

Beyond Equalization

Examining Fiscal Transfers in a Broader Context

Edited by Jason Clemens and Niels Veldhuis



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Contents

- About the authors / iv
- Acknowledgments / vii
- Introduction / viii
- 1 Fiscal balance, the GST, and decentralization / 3**
Jason Clemens, Niels Veldhuis, and Milagros Palacios
- 2 Questioning the legality of equalization / 25**
Burton H. Kellock, Q.C. and Sylvia LeRoy
- 3 Assessing the pre-2004 equalization program / 47**
Kumi Harischandra and Niels Velhuis
- 4 Equalization reforms: A review of prominent proposals / 67**
Jason Clemens and Kumi Harischandra
- 5 Solutions to equalization / 107**
Fred McMahon and Jason Clemens

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Any remaining errors, omissions, or mistakes remain the sole responsibility of the individual authors and the editors. As the authors have worked independently, the views and analysis expressed in this document remain those of the authors and do not necessarily represent those of the supporters, trustees, or other staff at The Fraser Institute.

Introduction

Jason Clemens and Niels Veldhuis

Canada is faced with a tremendous opportunity to improve and strengthen the federation in a fundamental way. The country is enjoying a strong period of economic performance—it is now in its fourteenth year of economic expansion—but faces a number of challenges: a deteriorating health system, lagging productivity, over taxation, continuing conflict between federal and provincial governments, and a marked divide between laggard provinces and those that are prosperous.

This book provides a road map for a better Canada based on decentralization, greater accountability, and a more efficient and sustainable fiscal framework. Unlike many other volumes that have analyzed equalization alone, this book takes a broader view of fiscal transfers. Indeed, the first chapter of the book outlines the various transfer programs currently in place and the varying levels of provincial dependence on federal transfers. In addition, the chapter examines the claims of fiscal imbalance empirically. More importantly, it offers a solution that would see greater accountability introduced into government through decentralization, clarified areas of responsibility, and a dramatically improved tax system.

The remaining four chapters of the book address different aspects of the equalization debate. Chapter two deals with one that is most often ignored: its legality. The legal scholar, Burton Kellock, Q.C., and Sylvia LeRoy, Senior Policy Analyst with The Fraser Institute, investigate the legality of equalization and the larger issue of federal spending in areas of provincial

responsibility. At a minimum, this chapter should give pause for concern to those who begin and end all conversations considering equalization as a constitutional imperative.

The next two chapters provide background on equalization. Chapter three summarizes past research on equalization and outlines the many problems identified in the program before 2004, when the federal government implemented a “New Framework” for equalization that effectively eliminated its rules-based nature. In addition, a number of side agreements were subsequently signed with provinces that further undermined the rules-based foundation of equalization. The most notable of these side agreements was the Offshore Atlantic Agreement 2005 with Newfoundland and Labrador. The problems with the pre-2004 equalization program described in this chapter are critical given that many experts lean towards re-establishing equalization as a rules-based program.

Chapter four summarizes a series of studies that have recommended reforms to equalization. It is meant to provide the reader with an overview of the issues currently being debated, the options for reform available, and the areas in which consensus has emerged. The chapter examines in depth the recent report by the federal government’s Expert Panel on Equalization and Territorial Formula Financing, *Achieving a National Purpose: Putting Equalization Back on Track*, as well as *Reconciling the Irreconcilable: Addressing Canada’s Fiscal Imbalance*, a study published by the Council of the Federation (provinces). It also considers studies and reports by some of Canada’s leading economists and public-policy analysts on the issue of equalization reform.

The final chapter of the book is by noted writer and economist Fred McMahon, Director of Globalization and Trade at The Fraser Institute, and Jason Clemens. Mr. McMahon is the author of numerous research articles and several books on the general topic of fiscal transfers, including *Looking the Gift Horse in the Mouth: The Impact of Federal Transfers on Atlantic Canada*, which won the Sir Antony Fisher International Memorial Award for advancing public-policy debate, *Road to Growth: How Lagging Economies Become Prosperous*, and *Retreat from Growth: Atlantic Canada and the Negative Sum Economy*. Chapter five outlines a series of principles and specific reforms that the authors argue will improve equalization compared to its pre-2004 status quo.

Together, these chapters form a powerful vision by some of Canada’s leading economists and scholars of a more sustainable and productive Canadian federation based on improved government accountability, more efficient

social programs, and a more efficient and competitive tax system. It is our sincerest hope that this volume will not only stimulate debate and discussion about the various topics covered but that it will provide specific direction for reforms over the next year.

One topic that is not discussed in this book, but which we hope will emerge as an issue, is the very existence of equalization. The chapters in this book were purposefully designed to provide guidance towards incremental improvements in the equalization program, improvements that Canada currently has the opportunity to make. However, considering improvements should not prevent the more fundamental discussion of whether the equalization program, even when improved, provides a net benefit to either the country as a whole or individual provinces. We hope that there will emerge a rational debate, founded on empirical evidence, about the efficacy of continuing even an improved equalization program.

Beyond Equalization

Fiscal balance, the GST, and decentralization

Jason Clemens, Niels Veldhuis, and Milagros Palacios

Introduction

The debate over the fiscal balance between the provinces and Ottawa is as old as the country itself. Over the last decade however, this debate has taken on heightened interest as Ottawa enjoyed increasing surpluses while the provinces generally struggled to provide the bulk of government programs while balancing their financial books. In addition, the last decade or so has seen the federal government increasingly active in areas of sole provincial responsibility. As such, there is increasing recognition of the need for a rebalancing of the Canadian federation. There is also a simultaneous realization of the need for a better tax system in Canada that will promote and encourage diligence, savings, investment, and entrepreneurship. Canada enjoys an historic opportunity today to concurrently rebalance the federation, improve the country's tax system, and inject much needed accountability into government programs.¹

¹ One of the problems with both past and present debate and research on the fiscal imbalance is that they tend to discuss the federal government's largest transfers to the provinces, equalization and social transfers, in isolation from one another. This oversight often leads the authors to underestimate the effect of fiscal transfers from the federal government to

The first section of this publication provides an overview of cash transfers from Ottawa to the provinces along with an analysis of the level of provincial dependence on federal cash transfers. The second section outlines the need for rebalancing within the federation based on greater accountability. The final section gives the recommendations for reform.

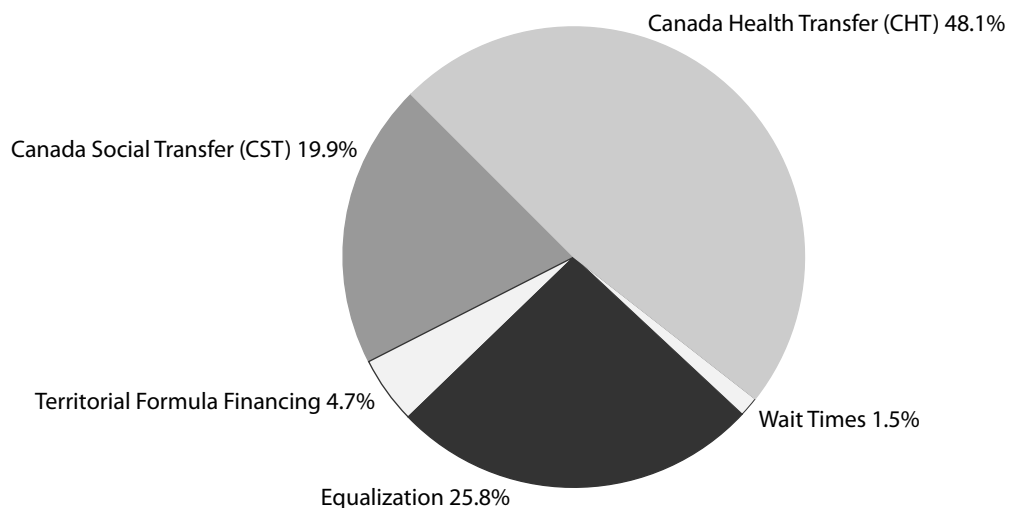
1 Components of fiscal cash transfers

In 2005/06, the federal government provided a total of \$42.3 billion in cash to the provinces and territories.² This represents a little over 17.0% of the revenues raised independently by the provinces.

Figure 1.1 illustrates the composition of federal cash transfers. The Canada Health Transfer (CHT), which stood at \$20.3 billion in 2005/06, represents nearly half (48.1%) of total federal government's cash transfers to the provinces. The next largest transfer is Equalization, which totalled \$10.9 billion and represented a little over one-quarter (25.8%) of all cash transfers.³ The Canada Social Transfer (CST) was the third largest envelope of federal cash transfers at \$8.4 billion (2005/06). The CST is intended to aid provincial spending on post-secondary education and social assistance broadly defined. There are several other transfer programs but these three—Canada Health Transfer, Equalization, and the Canada Social Transfer—constitute the overwhelming majority (93.8%) of fiscal cash transfers to the provinces from the federal government.

the provinces. This study is part of a larger project that will examine the issue of fiscal flows and balance within Canada more extensively.

- 2 This figure does not include tax-point transfers, which totaled \$19.3 billion in 2005/06. In addition to the cash transfers it provided to the provinces, the federal government also gave \$12.0 billion under the Canada Health Transfer (CHT) and \$7.3 billion under the Canada Social Transfer (CST) as tax-point transfers. The federal government defines a "tax transfer" as "the federal government ceding some of its 'tax room' to provincial governments. Specifically, a tax transfer occurs when the federal government reduces its tax rates to allow provinces to raise their tax rates by an equivalent amount. With a tax transfer, the changes in federal and provincial tax rates offset one another and there is no net financial impact on the taxpayer. Tax transfers represent a growing source of revenue for provinces since they increase in value over time with growth in the economy" <http://www.fin.gc.ca/gloss/gloss-t_e.html#tax_transfer>. For further information, please see the website of the federal Finance Department, <www.fin.gc.ca/fin-eng.html>.
- 3 Not all provinces receive equalization payments though all receive the Canada Health Transfer (CHT) and the Canada Social Transfer (CST).

Figure 1.1: Components of federal cash transfers (2005/06)

Source: Canada, Department of Finance, 2006b and 2006c.

Varying levels of provincial dependence

Some provinces rely on federal transfers more than others. Obviously the greater the percentage of a province's revenues is made up of federal transfers, the greater their dependence on federal transfers. Table 1.1 shows the percentage of each province's total revenue provided by federal cash transfers in 2005/06 and, thus, the degree of provincial dependence upon transfers.

The percentage of provincial revenues provided by federal transfers varies from a low of 10.4% in Alberta to a high of 58.7% in Newfoundland and Labrador.⁴ The high level of dependence on federal cash transfers in Newfoundland and Labrador, even among those provinces that are highly dependent, is largely due to the effects of the Atlantic Offshore agreement, which is a one-time occurrence. In 2004/05, Newfoundland and Labrador's

-
- 4 There are a variety of reasons for the differing provincial levels of dependence on federal transfers. For example, provinces that are deemed to be eligible for equalization will obviously receive monies while those provinces deemed to be contributors are not eligible for payments. Related to the issue of equalization is the distribution of income across the country. Provinces that have higher income levels, on average, are able to collect more revenues compared to provinces with lower incomes, *ceteris paribus*. Yet another possible explanation is access to different types of revenues. Provinces in western Canada, for example, are currently enjoying strong revenue growth in part because of their ability to capitalize on their natural resource endowments and strong commodity prices for those resources.

Table 1.1: Total Federal Government Transfers to the Provinces (2005/06)¹

	BC	AB	SK	MB	ON	QC	NB	NS	PE	NL ²
Total own-source revenues (in \$ millions)	28,333	32,260	7,586	6,950	73,393	57,354	4,177	4,985	746	2,902
Total transfers from the federal government (in \$ millions)	5,737	3,736	1,655	3,009	13,417	11,957	2,329	3,258	451	4,125
Total revenues (in \$ millions)	34,070	35,997	9,241	9,959	86,811	69,311	6,507	8,243	1,196	7,027
Total transfers as a percentage of total provincial revenues	16.8%	10.4%	17.9%	30.2%	15.5%	17.3%	35.8%	39.5%	37.7%	58.7%
Own-source revenues as a percentage of total provincial revenues	83.2%	89.6%	82.1%	69.8%	84.5%	82.7%	64.2%	60.5%	62.4%	41.3%

Note 1: The data contained in this table relies on FMS provincial and territorial general government revenues and expenditures.

Note 2: There is a significant difference in the transfers from the federal government to Newfoundland from 2004/05 to 2005/06. The year-to-year difference in transfer revenues for Newfoundland from 2004/05 to 2005/06 can be attributed mainly to revenues related to the federal/provincial Atlantic offshore agreement, which was signed by the province in 2005. According to this agreement, the Government of Canada will provide the Government of Newfoundland and Labrador a payment of \$2.0 billion. In 2004/05, the total federal transfers as a percentage of total provincial revenues in Newfoundland were 40.1%, markedly below the 58.7% recorded in 2005/06.

Source: Statistics Canada, Public Institutions Division, Financial Management System (FMS), 2006; calculations by the authors.

receipt of federal cash transfers constituted 40.1% of total revenues. However, even at this reduced rate Newfoundland and Labrador still has the highest level of reliance on federal cash transfers of any province.

In all, there are five provinces that have a relatively high reliance on the federal government for revenues: Newfoundland and Labrador, 58.7% (40.1% in 2004/05); Nova Scotia, 39.5%;⁵ Prince Edward Island, 37.7%; New Brunswick, 35.8%; and Manitoba, 30.2%.

The remaining five provinces rely comparatively less on federal government transfers and more on their own sources of revenues. However, federal cash transfers to these five provinces still range from 10.4% in Alberta to 17.9%

5 Nova Scotia also had an Atlantic Offshore agreement with the federal government that exempted offshore oil and gas revenues from equalization claw-backs; however, it had less impact on Nova Scotia's total provincial revenues than it did on those of Newfoundland and Labrador.

in Saskatchewan. In other words, even the provinces that have relatively lower dependence upon the federal government receive between 1 and 2 dollars out of every 10 from Ottawa.

**Not just government-to-government transfers:
Redistribution through Employment Insurance**

While outside the scope of this study, there are more than just government-to-government transfers affecting the provincial economies. For example, there is a strong redistributive component in the country's Employment Insurance (EI) program. Table 1.2 shows, by province, the value and percentage of contributions collected from, and benefits disbursed to, individuals for 2003, the latest year for which comparable data are available.

Table 1.2: Employment Insurance (EI) contributions and benefits (\$ millions) (2003)¹

Federal (total)	BC	AB	SK	MB	ON	QC	NB	NS	PE	NL
Total EI Contributions										
18,513	2,222	2,063	498	641	7,490	4,296	397	493	70	233
<i>Share of Total Provincial Contributions</i>										
	12.0%	11.1%	2.7%	3.5%	40.5%	23.2%	2.1%	2.7%	0.4%	1.3%
Regular EI Benefits										
8,769	1,041	558	191	210	2,326	2,789	517	435	119	540
Other EI Benefits²										
4,430	536	425	110	153	1,578	1,027	149	166	57	212
Total EI Benefits										
13,199	1,577	982	301	363	3,904	3,816	667	601	175	752
<i>Share of Total EI Benefits</i>										
	11.9%	7.4%	2.3%	2.7%	29.6%	28.9%	5.1%	4.6%	1.3%	5.7%
Difference in Dollars										
	645	1,081	197	278	3,586	480	(270)	(108)	(105)	(519)
Difference in Percentage										
	0.1%	3.7%	0.4%	0.7%	10.9%	-5.7%	-2.9%	-1.9%	-1.0%	-4.4%

Note 1: 2004/05 EI benefits data is available, but the latest information available regarding contributions is 2003.

Note 2: Takes into account benefits payments under fishing, special (sickness, maternity, parental, compassionate), employment (section 25 of the Employment Insurance Act) and Work Sharing benefits. Dollar figures encompass Family Supplement top-ups paid.

Source: Canada, Human Resources and Skills Development, 2006; calculations by the authors.

Individuals in the three traditional wealthy (“have”) provinces of British Columbia, Alberta, and Ontario along with Saskatchewan, Manitoba, and Quebec are aggregate net contributors to the EI program. That is, the federal government collects more revenues from workers (in total) from these provinces than it pays in benefits. On the other hand, the four Atlantic provinces all receive more benefits than the revenues collected.⁶

The Employment Insurance program is, therefore, an example of a federal program that transfers income to individuals but still acts to transfer income from a group of net contributing provinces to net recipient provinces. Such a redistributive program has important economic effects on both the individual recipients and the provinces that are net beneficiaries.⁷

Conclusion

In the most recent fiscal year (2005/06), the federal government provided the provinces with \$42.3 billion in cash transfers, which represented a little over 17.0% of the revenues raised independently by the provinces. The percentage of provincial revenues provided by federal transfers varies from a low of 10.4% in Alberta to a high of 58.7% in Newfoundland and Labrador. The four Atlantic Canadian provinces along with Manitoba have relatively high levels of dependence on federal cash transfers (30.2% to 58.7%) compared to their total revenues. However, even the remaining five provinces that rely comparatively less on federal government transfers still receive material amounts of their total revenues from the federal government (10.4% to 17.9%). In other words, even the provinces that have relatively lower dependence upon the federal government receive between 1 and 2 dollars out of every 10 from Ottawa.

6 Another way in which to examine the mix of revenues collected and benefits paid is by looking at the percentages of each. Again British Columbia, Alberta, and Ontario, the three traditional “have” provinces, along with the Prairie provinces of Manitoba and Saskatchewan contribute more proportionately than they receive in aggregate EI benefits. On the other hand, Quebec and the four Atlantic provinces all contribute less proportionately than they receive in aggregate EI benefits.

7 For a detailed analysis on the effects of (un)employment insurance, please see Grubel and Walker, 1978. For additional information, please see Kuhn and Riddell, 2006; Scarpetta, 1996; Christofides and McKenna, 1996; and Corak, 1993.

2 Rebalancing the federation

Much has been made over the last few years of “fiscal imbalance.” Although this term has multiple meanings, most of the discussion has surrounded the large surpluses enjoyed by Ottawa at the same time that many provinces were struggling to finance programs such as health and education.⁸ There are two core issues in the debate regarding fiscal imbalance: empirical evidence of its existence, and accountability. The first issue is simply whether or not there is an imbalance between the revenues and spending responsibilities of the federal and provincial governments. The second issue is whether or not the separation of revenue raising and program provision reduces accountability.

Is there a fiscal imbalance?

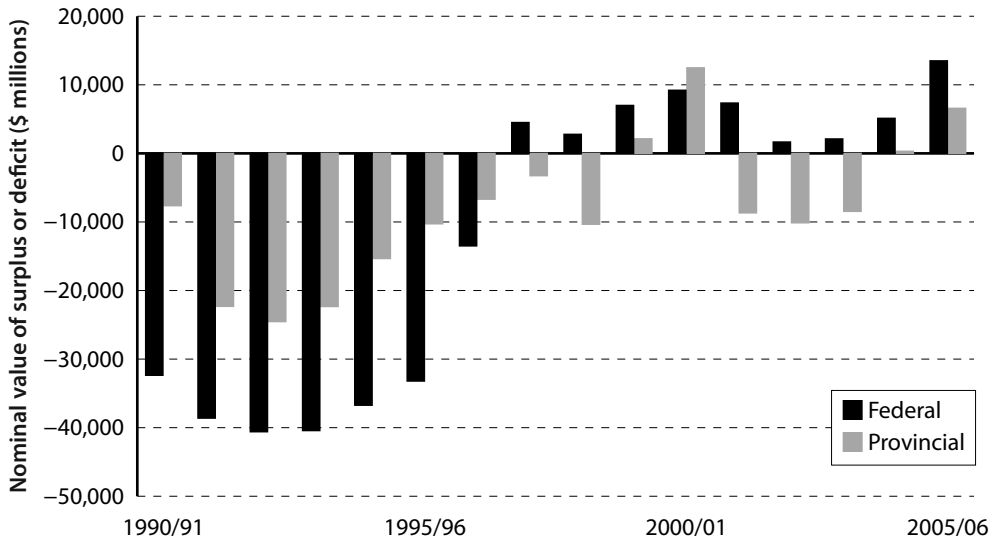
Figure 1.2 illustrates the nominal net fiscal balance (surplus or deficit) for the federal government and all of the provincial and territorial governments (consolidated) between 1990/91 and 2005/06.⁹ The federal government begins the period with an enormous deficit of \$32.4 billion while the provinces had a much lower, collective deficit of \$7.6 billion. In 1997/98, however, the federal government began operating in surplus while the provinces were still collectively struggling to balance their fiscal affairs. Specifically, in 1997/98, the federal government recorded a surplus of \$4.5 billion while the provinces had a collective deficit of \$3.3 billion.

The provinces have collectively turned the fiscal corner and are now recording aggregate surpluses. In fact, Canada as a whole is experiencing quite strong fiscal performance: Statistics Canada recently reported that in 2005/06 all governments in Canada (federal, provincial, and local) recorded the second largest surplus (\$26.0 billion) in the last 20 years (Statistics Canada, 2006).¹⁰

8 The federal government outlined these problems in its *Budget Plan 2006* (Canada, Dep't of Finance, 2006a) as well as the supplementary document, *Restoring Fiscal Balance in Canada: Focusing on Priorities* (Canada, Dep't of Finance, 2006d).

9 Please note that the data used throughout this section is based on Statistics Canada's Financial Management System (FMS) and will, therefore, deviate from the budget and public accounts data in certain circumstances.

10 The size of the fiscal difference between the federal and provincial governments is best understood by comparing the aggregate fiscal balances of each since 1997/98. The federal government has experienced a cumulative surplus of \$53.3 billion since 1997/98 while the provinces have incurred a cumulative deficit of \$14.0 billion.

Figure 1.2: Federal and provincial fiscal balances (1990/91–2005/06)

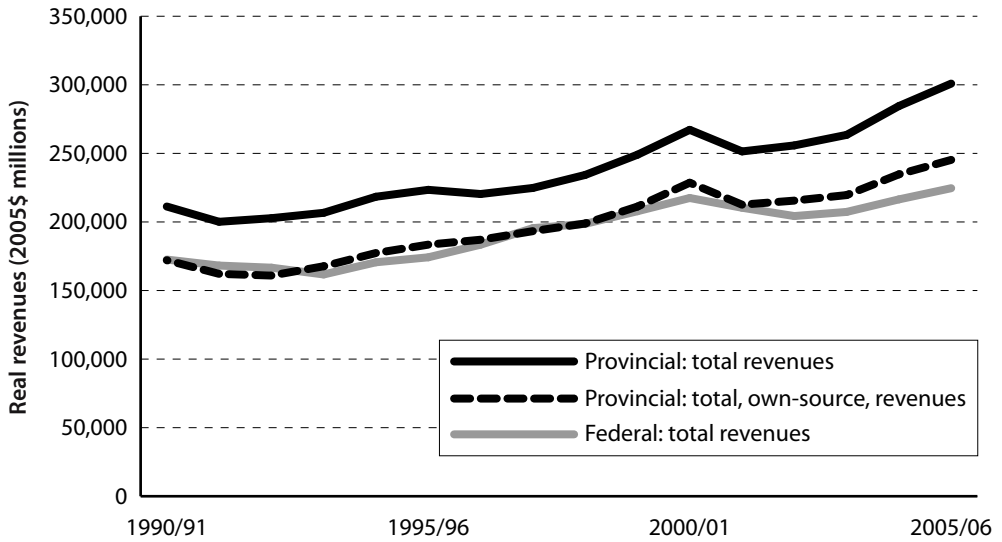
Source: Statistics Canada, Public Institutions Division, Financial Management System 1999–2006.

Comparing revenue and spending

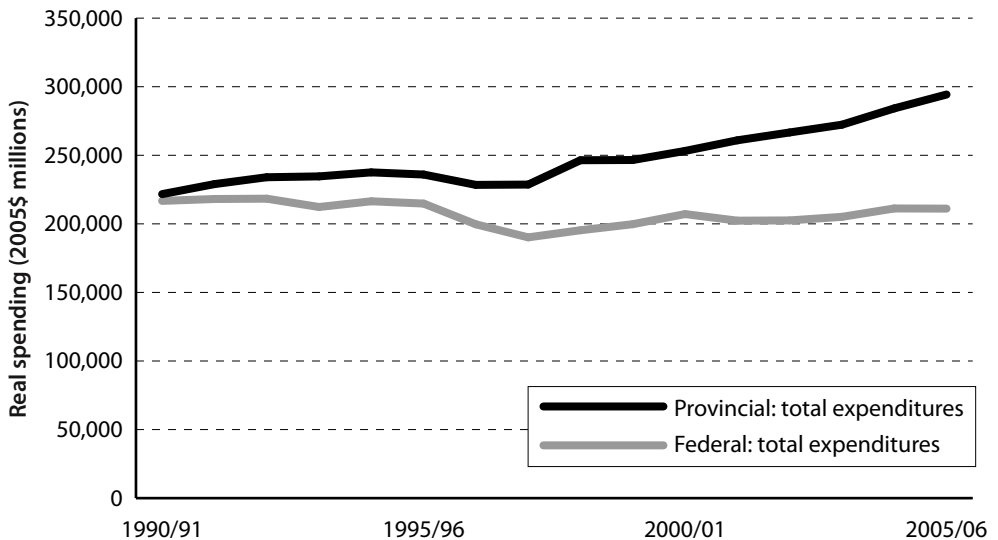
One of the myths of the fiscal imbalance is that the provincial governments are not collecting enough revenues. Figure 1.3 illustrates the growth of inflation-adjusted (real) federal and provincial revenues between 1990/91 and 2005/06. Two series are presented for the provinces: total revenues and total own-source revenues. The more relevant statistic is own-source revenues, which exclude transfers from the federal government.

The federal government and the provinces begin the period with essentially the same amount of inflation-adjusted revenues: \$172.6 billion (federal) compared to \$172.1 billion (provinces). By 2005/06, cumulative own-source revenues for the provinces outweigh the revenues of the federal government by \$20.7 billion. Real revenues for the federal government have grown, on average, 1.8% over the period while real own-source revenues for the provinces have grown at 2.5%. It is, therefore, quite difficult to argue that the provinces have lacked revenues compared to the federal government when discussing the fiscal imbalance.

Much more telling and explanative of the current fiscal imbalance is the relative spending of the two levels of government as depicted in Figure 1.4, which illustrates inflation-adjusted spending by the federal and provincial governments between 1990/91 and 2005/06. In real terms, the federal government is spending slightly less in 2005/06 than it did in 1990/91. The provinces,

Figure 1.3: Federal and provincial real revenues (1990/91–2005/06)

Source: Statistics Canada, Public Institutions Division, Financial Management System 1999-2006; calculations by the authors.

Figure 1.4: Federal and provincial real spending (1990/91–2005/06)

Source: Statistics Canada, Public Institutions Division, Financial Management System 1999-2006; calculations by the authors.

on the other hand, are spending over \$72.6 billion more (a growth of 32.8%) in 2005/06 in inflation-adjusted terms than they were in 1990/91. The provinces spent \$4.9 billion more than the federal government in 1990/91; this difference has increased to over \$83.2 billion in 2005/06.

It is quite clear that one of the driving forces behind the current fiscal imbalance is the difference in spending growth over the last decade and a half. Part of the explanation for these differences is the rather large increases in spending on health, education, and social assistance by the provincial governments.

Of equal importance, however, and critical to the debate on fiscal imbalance, is the nature of federal spending. Figure 1.5 depicts growth in a selected number of federal spending categories between 1990/91 and 2005/06. The figures are presented as a percentage of total program spending rather than total spending to reflect the dramatic changes in debt-service costs at the federal level.¹¹

Between 1990/91 and 2005/06, a number of key areas of federal responsibility such as the protection of people and property (including national defence) and transportation and communication infrastructure have all declined as a percentage of total federal program spending. Other areas, such as foreign affairs, have essentially stagnated. This has occurred while the federal government dramatically increased its funding of provincial areas of responsibility such as health, education, and social assistance through its transfer programs (CHT and CST) as well as a number of direct spending programs.

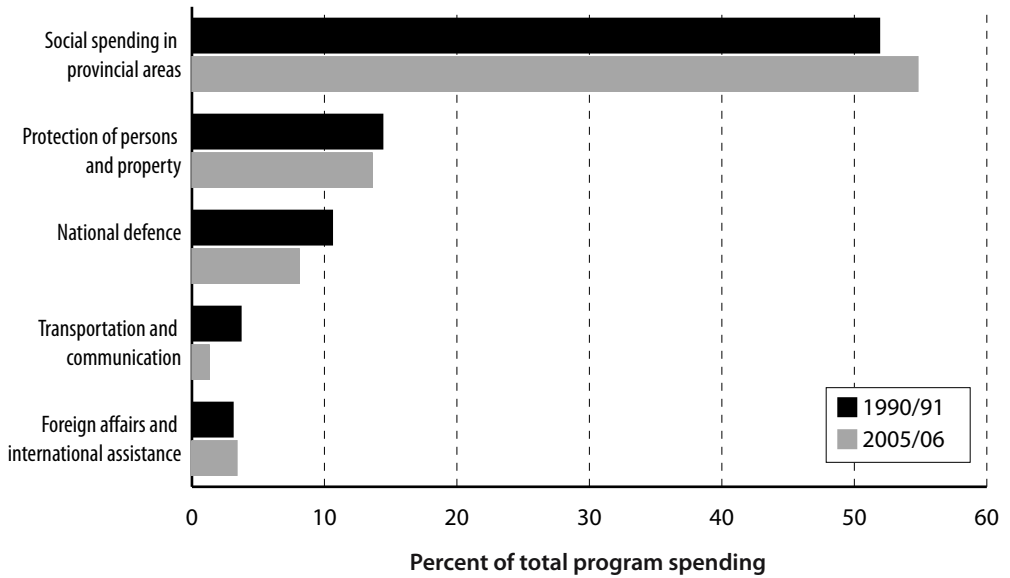
Figure 1.6 illustrates the inflation-adjusted spending in three key federal areas of responsibility (protection of persons and property, national defence, and transportation and communications) over the same time period. The trend line for both national defence and transportation and communications is decidedly negative while real expenditures on the protection of people and their property is essentially flat. These trends exist within a framework that has seen federal spending on provincial areas of responsibility such as healthcare and education increase markedly.

Conclusion

Both the federal and provincial governments have experienced strong revenue growth over the period examined. The provincial governments, however, have had much larger spending increases, in part due to pressures in three of the

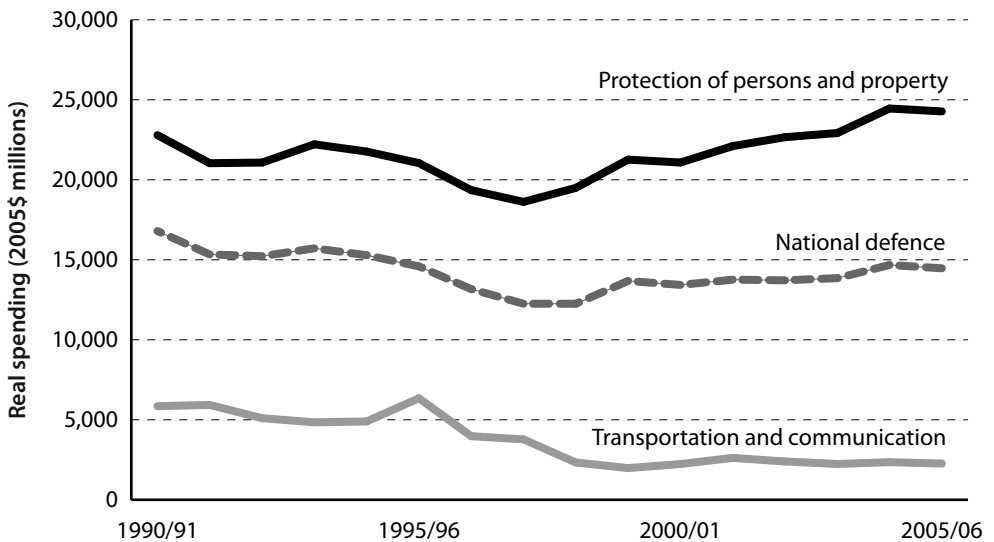
¹¹ The federal government has enjoyed a marked decline in the dollar cost and percentage of spending allocated to debt servicing costs. Debt servicing costs peaked in 1996/97 at \$44.9 billion, 27.1% of total expenditures. They have since declined to \$32.0 billion in 2005/06, 15.2% of total expenditures.

Figure 1.5: Selected areas of federal spending as a percentage of total program spending (1990/91 and 2005/06)



Note: Social Spending in provincial areas includes both direct spending on health, education, and social assistance as defined by Statistics Canada (FMS) as well as the CHT and CST, which are dedicated transfers.

Figure 1.6: Selected areas of federal spending (1990/91–2005/06)



Source: Statistics Canada, Public Institutions Division, Financial Management System 1999–2006; calculations by the authors.

largest programs provided by the provinces: health, education, and social assistance. This can be best seen by the stable and indeed rising surpluses of the federal government compared to much tighter fiscal balances for the provinces in a period when provincial revenue growth was stronger than the federal government. In addition, it is critical to note the changing nature of federal spending as outlined above. Over the course of the period examined, the federal government tended to neglect core areas of federal responsibility while increasingly involving itself in provincial areas of responsibility.

Accountability: A critical component of reform

Those who believe that the “fiscal imbalance” is a serious problem that must be addressed commonly propose that the federal government increase its transfer payments to the provinces, particularly, the Canada Health Transfer (CHT) and the Canada Social Transfer (CST).¹² Simply increasing the CHT and CST would, however, retain the federal government’s role in these provincial areas of responsibility. The recent federal document *Restoring Fiscal Balance in Canada* clearly acknowledged that K-12 education, health, municipalities, social assistance, and social services were exclusive areas of provincial jurisdiction (Canada, Dep’t of Finance, 2006d: 20). This is an important recognition by the federal government and offers a genuine opportunity for reform.

A key principle to be applied in evaluating reform should be accountability. That is, how transparent and understandable is both the financing and provision of services. Currently, both the federal and provincial governments collect revenues to support these programs. The federal government then transfers monies to the provinces to assist in financing the provision of these programs, often with conditions. The provinces then directly provide the programs.

A far more accountable system is to remove the federal government from this activity in order to have one level of government responsible for both the raising of revenues (taxes) and the provision of programs and services. This improves accountability since there is no longer confusion or ambiguity about responsibilities. The provinces would be required to raise necessary revenues and then provide high-value services.¹³ An additional benefit would be that the provinces would be freer to experiment in how best to provide the

12 The high-profile expert panel appointed by the Council of the Federation—a provincial body—recommended large-scale increases in both equalization as well as the CHT/CST. See Council of the Federation, 2006.

13 Please note that “provide” does not necessary mean provision of services by the public sector. Rather, it refers to a general provision through financing, regulating, contracting, or direct provision of goods and services to citizens.

goods and services demanded by their citizens than is currently the case due to conditions imposed by the federal government. Welfare and K-12 education are two excellent examples of areas that benefit from provincial autonomy and experimentation.¹⁴

3 A plan to decentralize by making greater use of the GST

A plan for genuine decentralization, unlike the calls to increase federal transfers to the provinces, requires that the federal government reduce its taxes so that provinces can simultaneously increase theirs, with no net tax increase. Such a reform means that provinces raise more of their revenues from their own sources and rely less on the federal government for transfers. A critical decision is what type of taxes the federal government should reduce and what types of taxes the provinces should increase.

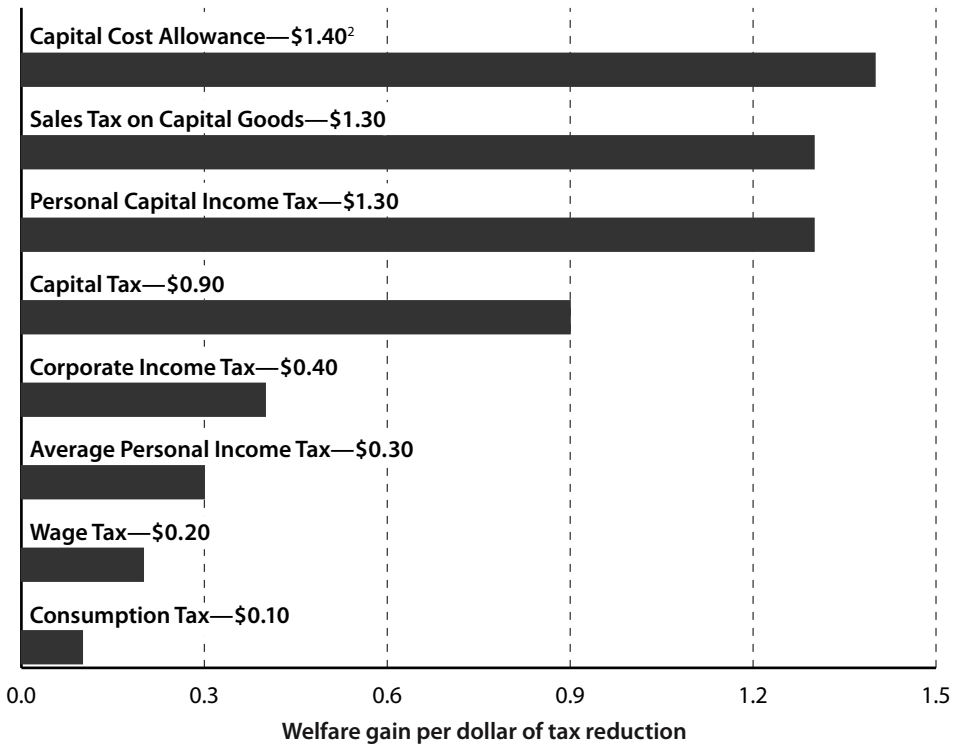
Changing the tax mix

There is widespread agreement amongst economists that the reductions in consumption taxes, such as the GST are the least productive tax cuts available (Veldhuis and Clemens, 2006). Indeed, a recent study by the federal Department of Finance (Baylor and Beausejour, 2004) confirm the small benefits garnered from a cut in consumption taxes such as the GST compared with other types of tax relief. Figure 1.7 gives estimates of “welfare gains” or benefits from different types of tax cuts.

Baylor and Beausejour estimated the benefits of a \$1 reduction in consumption taxes such as the GST at \$0.10.¹⁵ This compares poorly with the level of benefits available from the same size of tax cut (\$1) but in different forms. For example, reductions in personal income taxes generated benefits of \$0.30. The tax relief that generated the largest benefits were those that reduced taxes on capital: capital cost allowance or more commonly depreciation allowances (\$1.40), sales taxes on capital goods or business inputs (\$1.30), and corporate capital taxes (\$0.90).

14 For more on welfare and K-12 education reform, please see Faguet and Sanchez, 2006; Harris and Manning, 2005b; Hepburn and Robson, 2002; Schafer et al., 2001; Hepburn, 2001; Richards and Poschmann, 2000; Karlsen, 1999; Richards, 1997; and Boessenkool, 1997.

15 Benefits of different types of tax cuts were calculated by assuming that any revenue loss was offset by a non-distortionary “lump-sum” tax increase. In other words, tax changes are revenue neutral. The lump-sum tax does not distort individual and firm behaviour by altering the incentives to work, save, invest, or undertake risk.

Figure 1.7: Estimated welfare gains from various tax reductions¹

Note 1: Revenue loss is assumed to be recovered through “lump-sum” taxation. Welfare gains are calculated as the gain in economic well-being per dollar of tax reduction.

Note 2: The estimate for an increase in capital cost allowances (CCA) is for new capital only. Increasing CCA is not a tax reduction per se but rather an increase in a deduction against corporate income taxes.

Source: Baylor and Beausejour, 2004.

The benefits of different types of tax cuts are based on incentive effects. For instance, personal income tax and capital-based taxes influence the decision of individuals to work, save, invest, and undertake entrepreneurial activities. A reduction in this kind of taxes, therefore, encourages these activities.¹⁶ On the other hand, reductions in consumption taxes such as the GST make current consumption less expensive and, thus, do not improve the incentives to save and invest. It is these pronounced differences in incentives that result in large differences in the benefits provided by different tax cuts.

International competitiveness must also be considered as a reason to move towards greater use of consumption taxes. Canada is already one

¹⁶ For a comprehensive review of the literature on taxes and incentives, please see Clemens and Veldhuis, 2005.

of the heaviest users among developed countries of income and profit taxes, two of the more distortionary and, thus, costly types of taxes. In fact, Canada had the fourth highest reliance on these types of taxes in 2003, the latest year for which data is available.¹⁷ A reduction in the GST means that Canada will actually rely proportionately more on profit and income taxes and less on consumption taxes. This will push Canada even further out on the fringes of the other OECD countries in terms of the structure of our tax burden.

Rebalancing Canada by making greater use of the GST

There are clearly benefits to using consumption taxes like the GST relatively more and using the more distortionary, high-cost taxes, such as capital-based taxes, less. The challenge is how Canada as a federation can use the GST more when the federal government has just implemented a reduction in the tax and has committed itself to an additional reduction over the next four years. The confluence of the federal government's decision to reduce the GST, the need for decentralization, and the advisability of greater reliance on consumption taxes offers the country a unique opportunity to achieve all three simultaneously.

A 3-step plan for reform¹⁸

Step 1: Eliminate transfers

The first step is for the federal government to eliminate the Canada Health Transfer (\$22.5 billion in 2007/08) and the Canada Social Transfer (\$8.8 billion in 2007/08) (Canada, Dep't of Finance, 2006d: 136).¹⁹ The elimination of these two transfer programs, which support provinces in providing services in provincial areas of responsibility would result in a decrease in federal spending of \$31.3 billion in 2007/08.

17 For further information and the specific data, please see Veldhuis and Clemens, 2006: 19.

18 There are a number of similarities between the proposal contained in this chapter for re-balancing the federation, installing more accountability in government, and improving the tax system and those in a study by Boothe and Hermanutz (1999) and, more recently, in a study by Professors Smart and Bird (2006).

19 The Canada Strong and Free series by former Ontario Premier Mike Harris and former Leader of the Opposition Preston Manning have called for such a change for nearly two years. The three-volume series on this issue offers a wealth of reasoning and explanation as to the benefits of such a change.

Step 2: Reduce federal taxes

The second step is to concurrently reduce federal taxes. The tax reduction should aim (1) to allow provinces to increase their own taxes as needed to compensate for the loss of CHT and CST transfers, and (2) to improve the country's tax system by increasing its efficiency and competitiveness through greater reliance on consumption taxes.

As discussed, part of that reduction in federal taxes would be needed to accommodate the additional reduction of 1-percentage point in the GST that the federal government has already committed itself to.²⁰ The approximate cost of the additional reduction in the GST is \$5.2 billion (Canada, Dep't of Finance, 2006a: 65). Total federal spending on the CHT/CST program is forecast to reach \$31.3 billion for 2007/08. The elimination of the CHT and CST could finance the entirety of the GST tax reduction (1 percentage point) plus an additional \$26.1 billion in federal tax relief in 2007/08 alone.

This would allow for large-scale reductions in personal income taxes as well as business taxes, which would improve the efficiency of the tax system, its competitiveness, and the incentives for productive behaviour such as diligence, savings, investment, and entrepreneurship.²¹

Step 3: Increase provincial taxes

The final step is for the provinces to increase their own taxes to compensate for the loss of revenues from the elimination of the CHT and CST cash transfers. The provinces should increase, or adopt, the least costly (most efficient) tax available, which is a GST-based provincial sales tax. At this time, only four provinces (Quebec, New Brunswick, Nova Scotia, and Newfoundland and Labrador) have GST-type sales taxes. Five provinces have an independent provincial sales tax (PST) and Alberta has no provincial sales tax at all.

The provincial GST rates would have to be sufficient to raise the amount of revenue lost from the elimination of the CHT and CST. Table 1.3 contains CHT and CST cash transfer values by province for 2005/06. Using

20 In an ideal world, the already implemented GST reduction from 7% to 6% would be undone and the planned additional reduction of 1-percentage point foregone in order to allow for even more aggressive reductions in personal income taxes and business taxes. For the purposes of this study, however, we have assumed as given the already implemented GST reduction as well as the planned additional reduction.

21 For a discussion of prioritized tax relief, please see Veldhuis and Clemens, 2006; Caranci and Drummond, 2005; Chen and Mintz, 2004; Kesselman, 2004; Gentry and Hubbard, 2000; and Mintz and Wilson, 2000.

Table 1.3: CHT and CST cash transfers to the provinces (2005/06) (\$millions)

Federal (Total) [1]	BC	AB	SK	MB	ON	QC	NB	NS	PE	NL
Canada Health Transfer [2]										
20,310	2,805	1,776	698	777	7,624	5,013	497	619	91	341
Canada Social Transfer [2]										
8,415	1,188	682	303	329	3,105	2,122	210	262	39	144
Wait Times Reduction [3]										
625	82	63	19	23	243	147	15	18	3	10
Total CHT/CST Cash Transfers										
29,350	4,075	2,521	1,020	1,129		7,282	722	899	133	495

Note 1: Transfers to the Territories are included in the federal total but not delineated.

Note 2: This table only includes cash transfers for the CHT and CST; there are also tax point transfers.

Note 3: The Wait Times Reduction transfer is not an ongoing program and is unique to 2004/05 and 2005/06.

Source: Canada, Department of Finance, 2006c.

the Social Policy Simulation Demonstration Model (SPSD/M), a tax model from Statistics Canada, we calculated estimates of provincial GST rates required to compensate the provinces for the elimination of the CHT and CST.²² The GST rates required to replace the revenues received from federal CHT and CST payments ranged from a low of 4.2% in Alberta to a little over 7.1% in Newfoundland and Labrador (Table 1.4).²³ The non-weighted average for the ten provinces is 6.4%.²⁴

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- 22 The assumptions and calculations underlying the simulation results were prepared by the authors and the responsibility for the use and interpretation of these data is entirely theirs.
- 23 Note that it is possible that provinces would not have to replace the entirety of the monies lost through the elimination of the CHT and CST payments due to the increased flexibility and autonomy accorded them in the design and delivery of the underlying social programs. Note also that these calculations do not consider enhancement of the existing GST tax credit, which mitigates the effect of the GST on lower-income families by providing direct payments. It is certainly possible that some, if not all, of the provinces would enhance existing credits or implement new programs to further mitigate the effects of a higher GST.
- 24 If a standard provincial GST rate (estimated to be 6.4%) were implemented, there would be some provinces (Ontario, Alberta, and British Columbia) that would raise more money than required to cover the loss of revenues emanating from the elimination of the CHT and CST cash transfers. Alternatively, there would also be provinces (the remaining seven) that would

Table 1.4: Expected provincial GST rates required to compensate for the loss of CHT and CST revenues

	Provincial GST Rate		Provincial GST Rate
British Columbia	6.0%	Quebec	6.4%
Alberta	4.2%	New Brunswick	7.0%
Saskatchewan	7.0%	Nova Scotia	6.7%
Manitoba	6.9%	Prince Edward Island	6.7%
Ontario	5.6%	Newfoundland	7.1%

Note: The rates included in this table are in addition to the existing provincial sales tax rates.

Sources: Statistics Canada, Socio-economic Analysis and Modeling Division, 2006; calculations by the authors.

Convert PST to GST (Harmonization)

There is another issue arising from the implementation of GST-based sales taxes in the provinces. To date, only three of the four provinces that have GST-type sales taxes (New Brunswick, Nova Scotia, and Newfoundland and Labrador) have harmonized their systems with the federal GST. Quebec's GST-based system is independent of the federal GST (Treff and Perry, 2006: 58). Those provinces with independent provincial sales taxes (PST) should convert these to a GST similar to the federal GST as part of this reform process.

There are a number of reasons that harmonization makes economic sense. One, it reduces compliance costs for businesses and individuals that must file sales taxes since they would need to report only one tax. Two, it restructures the provincial sales taxes to exclude business inputs, which is a major flaw in the current tax system.²⁵

Major benefits for Canadians

The proposal to eliminate the federal CHT and CST coupled with reductions in federal taxes and increases in provincial taxes would yield a number of

raise insufficient revenues from a standardized GST to cover the revenue loss; they would be in a deficit. Some experts have recommended that this surplus-and-deficit situation resulting from a standardized provincial GST rate be dealt with under the auspices of equalization (Harris and Manning, 2005a, 2005b, and 2006).

25 The federal government outlined possible reform strategies in *Towards Replacing the Goods and Services Tax* (Canada, Dep't of Finance, 1996).

benefits. First, and perhaps most importantly, it would re-establish clearer lines of accountability and responsibility for critical areas such as health, education, and social assistance broadly defined. Second, it would markedly improve the country's tax system by increasing our reliance on efficient, low-cost, consumption taxes while reducing our use of less efficient, more costly, capital-based taxes. Third, it would reduce costs for businesses and individuals that file sales taxes since the number of reporting and administrative requirements would be cut in half. This proposal is a watershed rebalancing and improvement in the functioning of the Canadian federation.

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Questioning the legality of equalization

Burton H. Kellock, Q.C. and Sylvia LeRoy

Introduction

The inclusion of a commitment to equalization in the *Constitution Act, 1982* has led politicians, lawyers, economists, and citizens alike to assume that a federal program transferring money from all Canadian citizens to the governments of some “have not” provinces is a constitutional imperative. This assumption has been used both to justify the redistributive system and to oppose any changes that might limit the amount of the transfers made through the federal program. Before the costs (now nearly \$11 billion per year) and benefits of equalization are considered, the basic legal arguments that have supported the program deserve careful scrutiny.

This study uncovers two seldom-discussed problems. First, there is consensus that Canada’s constitutional commitment to equalization cannot be enforced by a court of law. Insofar as the commitment is a vague expression of political goals, the action that governments must take to fulfill it is open to debate. Second, this debate over the specific requirements of the Constitution’s equalization commitment ignores a more fundamental issue: equalization uses federal revenues to fund spending in areas of provincial jurisdiction. As a result, its legality cannot be resolved without considering the larger question of the federal government’s spending power.

Section one of this chapter examines the narrow question of equalization as it is included in section 36 of the *Constitution Act, 1982*, reviewing both published scholarly opinion and the original intentions of the Constitution's drafters. Section two addresses the broader question of the federal spending power in the light of the division of legislative powers between the federal and provincial governments enshrined in Canada's founding Constitution, the *British North America Act, 1867 (BNA Act)*. This division of powers, reinforced by early decisions of Canada's highest courts of appeal, poses a direct challenge to both the federal spending power and Canada's equalization program.

1 Equalization in the Constitution

A basic assumption is made, even by those who oppose equalization, that such payments are required under the Canadian Constitution and, accordingly, that any attempt to limit or suspend these payments can be prevented by a court of law. This assumption is based on the inclusion of a section in the *Constitution Act, 1982* pertaining to "equalization and regional disparities." Specifically, section 36(2) states: "Parliament and the government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation."

It is clear that the target recipients of the payments are provincial governments rather than individual citizens. The stated aim of equalization is to give governments resources (i.e. revenues) to spend on providing "comparable levels of public services," presumably services such as health care and education as distinct from individual income assistance. How these government-to-government transfer payments are to be made, or these services provided, is not specified. Insofar as these services are provided universally, this leaves open the possibility that income may be taxed from poor citizens in rich provinces to pay for services benefiting rich citizens in poor provinces (Hogg, 2000: ch. 6.6, 155; Usher, 1995; Poschmann, 1998).¹

To confuse the issue further, section 36(2) is riddled with non-specific terms. For instance, Parliament and the government of Canada are committed

1 For example, Poschmann (1998) found that an Alberta family with an income of \$30,000–\$40,000 contributed 9% to federal programs in 1997 but a Newfoundland family earning over \$100,000 received benefits equivalent to 1.2% of their income.

to the “principle,” not the practice, of making equalization payments, and no threshold is provided to clarify what level of services or taxation is considered either “reasonable” or “comparable.” The ambiguity of these terms raises questions as to their legal significance and invites competing interpretations of their practical application.

Scholarly consensus: Equalization is non-justiciable

Scholars considering the question have concluded that the equalization provisions lack the clear legal language needed for judicial review² or enforcement. As University of Alberta law professor, Dale Gibson, has observed: “... it could be contended that because s. 36(2) contains no reference to legislative jurisdiction, and employs soft terms like “committed” and “principle” rather than power-granting expressions like “may make laws,” it was not intended to have any direct legal effect” (Gibson, 1996). The ambiguity of these terms has contributed to a consensus amongst academics that “the constitutional obligation to make adequate equalization payments to the poorer provinces is probably too vague, and too political, to be justiciable” (Hogg, 2000: ch. 6.6, 156; see also Brown, 2002: 116; Milne, 1998: 176; Sossin, 1998).³ The implication of the ambiguity in section 36(2) is considerable: it means that a court cannot legitimately decide that section 36(2) imposes any definite or specific obligations on either the federal government or the provinces.

While ambiguity in constitutional law or language has not always dissuaded Courts from venturing their opinion, such judicial interventions on matters widely deemed “political” can pose a serious threat to the Supreme Court’s perceived legitimacy in a liberal democratic society. This has been referred to as the “counter-majoritarian difficulty” of judicial review (for further discussion, see Bickel, 1962; Manfredi, 1992). For this reason, even when such “political” questions have passed the initial test of justiciability, the Supreme Court has used great creativity to avoid answering definitively. To cite but one well-known example, when asked questions concerning the legality of Quebec secession—a matter upon which the Constitution was conspicuously silent—the Supreme Court left the matter open by inventing a “duty to negotiate” secession after a “clear majority” had voted affirmatively to a “clear question” on the subject (*Reference Re Secession of Quebec* [1998]). This did not resolve the issue: as Peter Hogg would later write, “it is not entirely clear why it [the duty

2 Judicial review refers to the power of courts to review and strike down or declare invalid government legislation, regulations, or behavior that conflicts with the supreme law of the Constitution.

3 Sossin (1998) refers to this as the “conventional view.”

to negotiate] is a legal rule, since it appears to have no legal sanctions” (Hogg, 1999; see also Walters, 1999: 389; Newman, 2001: 17, note 44). This ultimately deflected the matter back to the political arena for resolution.

While equalization appears in the written Constitution, its ambiguity and political nature nevertheless make it a constitutional oddity, its legal significance “one of the most puzzling parts of the *Constitution Act, 1982*” (Gibson, 1996: ¶69). Professor Peter Hogg, former Dean of Osgoode Hall Law School and one of Canada’s leading constitutional scholars, characterizes equalization as “statements of economic and social goals that ought to guide government but which are not enforceable in court” and likens the commitment to equalization in section 36(2) with the “directive principles of state policy” in the Constitution of India, which are also non-justiciable (Hogg, 2000: ch. 6.6, 156).⁴ At most, equalization payments may have assumed some of the characteristics of a constitutional convention, in that it is a practice widely acknowledged and accepted by political actors, but is unenforceable by courts as a matter of law.⁵

This makes equalization a political, not a legal issue, and any court asked to consider the matter would have to be cognizant of its “proper role within the constitutional framework of our democratic form of government” (*CAP Reference* [1991] at p. 545; *Reference Re Secession of Quebec* [1998] at para. 26). The proper role of the Court is to interpret the law and leave political matters—particularly decisions concerning the allocation of scarce tax dollars—to Parliament and the legislatures who have the technical expertise, institutional capacity, and democratic mandate to debate them properly.

Framers’ intent

Additional insight can be gained by examining the intentions of the federal and provincial governments that debated and ultimately agreed to include equalization in the *Constitution Act, 1982*. Transcripts from the Federal-Provincial Conference of First Ministers on the Constitution in 1980 casts light on these intentions.

According to Michael Trebilcock, now chair in Law and Economics at the University of Toronto’s Faculty of Law, who with Tanya Lee examined

4 The effect these principles in the Indian Constitution is discussed in Aikman, 1987.

5 Eugene Forsey expressed the common view when he described conventions as “first and foremost ... political: political in their birth, political in their growth and decay, and political in their application and sanctions. In politics they live and move and have their being” (Forsey, 1984: 13). The unenforceability of conventions has also been affirmed by the Supreme Court of Canada (*Patriation Reference* [1981]).

these documents, the principle or legitimacy of equalization was not questioned by the governments considering the matter. Notably, however, the transcripts from the First Ministers Conference also indicated that: "... it is clear that the governments believed that the mechanism and details of equalization were open to negotiation. Therefore, section 36(2) could only be seen to be violated where the principle of equalization, not merely the existing mechanism, has been abandoned by the federal government" (Lee and Trebilcock, 1987: 308).⁶ This intention is also apparent in the preamble to section 36, which stipulates that Parliament's commitment to the principle of equalization was to be fulfilled "[w]ithout altering the legislative authority of Parliament or of the provincial legislatures, or the rights of any of them with respect to the exercise of their legislative authority." Lorne Sossin, Associate Dean at the University of Toronto Faculty of Law, explains: "... the preamble makes clear that the federal and provincial governments are 'committed' to the goals set out in the section, not bound to achieve those goals. A 'commitment' can be expressed in many ways" (Sossin, 1998).⁷

Professor Hogg has noted, for instance, that federal contributions to shared-cost programs are "implicit equalization" insofar as the per-capita formula for federal financing of post-secondary education, hospital insurance, and medicare work to the benefit of have-not provinces who have both lower tax yields and less costly hospitals and universities (Hogg, 2000: ch. 6.8(a), 163, note 40). As such, the per-capita bloc grants provided through the Canada Health and Social Transfers (CHT and CST) could be construed as fulfilling Canada's section 36(2) commitment "to the principle of making equalization payments." If federal and provincial governments wish to be bound by a particular formula or schedule of payments that will realize the principle of equalization, this intention would have to be given concrete expression through a properly ratified constitutional amendment.

Attempted constitutional change: The 1992 Charlottetown Accord

Interestingly, a strengthened constitutional commitment to equalization was the objective of some provincial governments negotiating the package

6 See Government of Saskatchewan, 1980: 443–71 for further discussion. Notably, Lee and Trebilcock (1987) also assume the legality of the federal spending power.

7 As an example, Sossin suggests that Canada's commitment to the section 36(1)'s goals of promoting equal opportunities, reducing disparity by furthering economic development, and providing essential public services of "reasonable quality," could arguably be satisfied by provisions of the Canada Health and Social Transfer (CHST) providing a mechanism to develop shared principles (Sossin, 1998).

of amendments known as the 1992 Charlottetown Accord. After great debate over the meaning of the 1982 Constitution's equalization provisions, and the potential (or lack thereof) for judicial supervision and enforcement, the final text of the *Consensus Report on the Constitution* moved to amend section 36(2) to read: "Parliament and the Government of Canada are committed to making equalization payments so that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation" (Canada, Privy Council Office, 1992). In other words, rather than being merely "committed to the *principle* of making equalization payments" (*Constitution Act, 1982*; emphasis added), Parliament would thereafter be actually "committed to *making* equalization payments" (Canada, Privy Council Office, 1992, emphasis added).⁸ While this attempt to strengthen section 36(2) was defeated along with the entire package of amendments in a national referendum, the attempt illustrates the consensus that formal constitutional amendment would be needed before the equalization provisions could be enforced.

In summary, despite the assumption that any change to Canada's equalization system must pass judicial review for compliance with section 36(2) of the Constitution, there is broad agreement among legal scholars that this provision cannot be enforced in a court of law. The historical record reveals that this consensus opinion was shared by the provincial governments that ratified the *Constitution Act, 1982*, and that drafted a strengthened equalization clause in an attempt to remedy this legal deficiency in the Charlottetown Accord a decade later. This suggests that the fulfillment of the government's commitment to equalization is a matter on which only the court of public opinion, not a court of law, can render judgment.⁹

8 Thanks to Dr. J. Peter Meekison for drawing attention to this legislative history. Dr. Meekison is University Professor Emeritus of Political Science of the University of Alberta. From 1974 to 1984 he served with Alberta Federal and Intergovernmental Affairs, seven and one-half of those years as Deputy Minister. During the constitutional negotiations of 1978–1981, Dr. Meekison developed and prepared the formula, tabled by Alberta, that ultimately became the amending formula in the *Constitution Act, 1982*. As constitutional adviser to the Alberta government, he was actively involved in discussions of the Meech Lake Accord as well as the discussions leading to the 1992 Charlottetown Accord (committee co-chair).

9 While there are instances where the Supreme Court has "read in" new legal rules and rights that expressly conflict with legislative intent and written law (see for example *Vriend v. Alberta* [1998]; and *Delgamuukw v. British Columbia* [1997]), this practice is highly controversial and opens the Court to charges of judicial activism.

2 Constitutional division of powers

There is, however, the broader issue of whether the federal government even has the constitutional authority to collect federal taxes (revenues) and transfer those resources to provinces to spend in areas of their exclusive responsibility. The division of powers between the federal and provincial governments delineated in sections 91 and 92 of the *BNA Act, 1867* (since renamed the *Constitution Act, 1867*) was a core principle upon which Canada was founded (Vipond, 1991: 35; see also Romney, 1999; Ajzenstat et al., 1999: 261–326). In agreeing to a common Constitution, the founding fathers agreed that Parliament and the legislatures of each province would each have “exclusive” power to legislate in their respective spheres of jurisdiction. The boundaries of this jurisdiction would be policed by a neutral arbiter, namely courts with the power to strike down or declare invalid laws enacted by either level of government that fall *ultra vires* or “beyond the powers” of Parliament or the legislatures defined in sections 91 and 92.

Section 91 authorizes Parliament to make laws “in relation to all matters not coming within the classes of subjects by this Act assigned exclusively to the legislatures of the provinces”; for greater certainty, it listed specific matters that were to fall within federal jurisdiction. In all, 29 classes of subjects were listed, including exclusively “the public debt and property,” “the regulation of trade and commerce,” and “the raising of money by any mode or system of taxation.”¹⁰

While these federal powers of taxation may seem broad, there are clear limits to the purposes towards which these tax revenues may be directed. While all taxes and expenditures (federal or provincial) require legislative authority,¹¹ the BNA Act stipulates that “[i]n each Province the Legislature may *exclusively* make Laws in relation to Matters coming within the Classes of Subjects” enumerated in section 92 (emphasis added). Specifically, this section of the constitution gives provinces exclusive jurisdiction to use direct taxes to raise “revenue for provincial purposes,” which include “the establishment, maintenance, and management of hospitals,” “property

¹⁰ For the complete list of enumerated grounds, see the text of the *Constitution Act*, available online at <<http://lois.justice.gc.ca/en/const/index.html>>.

¹¹ See sections 53, 54, and 106 of the *Constitution Act, 1867*. This principle can be traced back to the 1688 Bill of Rights, which sought to ensure not merely that the executive branch was subject to the rule of law but also that the executive branch would have to call the legislative branch into session to both raise taxes and distribute appropriations.

and civil rights in the province,” and “generally all matters of a merely local or private nature in the province.”¹²

Canada’s highest court of appeal would later clarify the limits imposed by this division of powers, explaining: “... assuming that the Dominion has collected by means of taxation a fund, it by no means follows that any legislation which disposes of it is necessarily within Dominion competence ... To hold otherwise would afford the Dominion easy passage into Provincial domain” (*Unemployment Insurance Case* [1937]). Thus, any federal expenditures authorized by legislation “in relation” to matters that fall within the scope of subjects enumerated in section 92 necessarily conflicts with the higher law of the Constitution. As Pierre Trudeau wrote in 1957 (before entering political life), “if Ottawa regularly subsidized the construction of schools in all provinces on the pretext that the provinces did not pay sufficient attention to education, these governments would be attacking the very foundation of the federal system ... which does not give any government the right to meddle in the affairs of others” (Trudeau, 1968: 81). The same principle, he argued, applied to equalization grants.¹³

Constitutional authority for federal-provincial grants

There is only one provision of the Constitution that provides an exception to the stipulation that only the provinces may raise revenue for provincial purposes. Section 118 of the *BNA Act* required the federal government to pay the new provinces (Ontario, Quebec, Nova Scotia, and New Brunswick) fixed amounts of money on an annual basis. For example, Ontario was entitled to receive \$80,000 per year, Quebec would receive \$70,000, Nova Scotia, \$60,000, and New Brunswick, \$50,000. In addition, the federal government was required to pay an annual “grant in aid” to each province “equal to eighty cents per head of the population as ascertained by the census of 1861.”¹⁴

12 The *Constitution Act, 1982* extended this jurisdiction to include the exploration, development, conservation, management, and taxation of “non-renewable natural resources, forestry resources and electrical energy” (section 92A).

13 In Trudeau’s words: “I believe in equalization grants so long as they relate to that part of the general welfare that is under federal jurisdiction” (Trudeau, 1957: 82). He changed his mind on both equalization and the federal spending power only after assuming federal office (see Trudeau, 1969).

14 Section 119 provided an additional grant to the province of New Brunswick, while section 120 elaborated on the form of payment of the grants under sections 118 and 119. Supporters of the legality of equalization payments (and other conditional and unconditional grants by the federal government to the provinces) have relied on the provisions of the *BNA Act’s* section

The precise language used to authorize the transfer payments in section 118 of the *BNA Act* stands in sharp contrast to the ambiguity of the equalization provision in the *Constitution Act, 1982*. This suggests two key points. First, Canada's founding fathers accepted that particular circumstances surrounding the entry of some provinces into Confederation justified the transfer of federal tax revenues for provincial spending, notwithstanding the strict division of powers enumerated in sections 91 and 92 of the *Constitution*. Second, Canada's founding fathers sought to ensure that the grants under section 118 "shall be in full Settlement of all future Demands on Canada" (*BNA Act, 1867*), using clear language that would eliminate the possibility that the terms and conditions of these grants would be ambiguous enough to allow for contrary interpretation. In sharp contrast, the historical record suggests that it was the intention of the drafters of the *Constitution Act, 1982* to leave the interpretation and application of section 36(2) to the discretion of political actors.¹⁵

When the Prime Minister John A. MacDonald tried to use his prerogative to unilaterally offer "better terms" (i.e. increased subsidies) to Nova Scotia shortly after Confederation, the opposition pointed to the clear terms explicitly written into section 118 and argued it would take a formal constitutional amendment to alter the terms of the 1867 deal (Vipond, 1991: 41–44).¹⁶ As MP Edward Blake explained to the House of Commons on June 11, 1869, "this Parliament had no right to devote, from the service of Canada, for the support of the local governments, any sums of money whatever, except those (constitutionally) specified sums" (quoted in Vipond, 1991: 43). While MacDonald's

106, which authorizes payments "for the public service" to be made out of the federal consolidated revenue fund. While this has been used to justify the use of money obtained by taxes imposed for the purpose of supporting a wide range of public services that fall within provincial jurisdiction (i.e. health, education, and social services), in 1867 the phrase "the public service" was understood to mean the civil service. It is therefore not arguable that section 106, even if it stood alone, could authorize grants from the federal government to the provinces.

15 The narrow limits of section 118 also stands in sharp contrast to the explicit spending power granted Australia's federal Parliament in section 96 of the *Commonwealth of Australia Constitution Act, 1900*, adopted by the British Parliament in the same era as the *BNA Act*. According to section 96: "During a period of ten years after the establishment of the Commonwealth and thereafter until Parliament otherwise provides, *the Parliament may grant financial assistance to any State on such terms and conditions as the Parliament thinks fit*" (for discussion, see Quebec, Commission on Fiscal Imbalance, 2002: 24, f.n. 79; emphasis added).

16 MacDonald's offer of "better terms" for Nova Scotia was prompted by the strong anti-Confederation movement, which claimed 36 of 38 seats in the provincial assembly and 18 out of 19 federal constituencies in the elections of 1867 (Vipond, 1991: 41).

“better terms” resolution ultimately passed a vote in the House of Commons, Parliament would later recognize the need for formal constitutional amendment to end what Blake had rightly predicted would be “a general scramble for more money and increased subsidies by the other Provinces.” Consequently, in 1907 the Canadian Speaker of the Senate and the Speaker of the House of Commons petitioned the King to amend the Constitution to authorize a “final and unalterable settlement” of provincial subsidies (Ollivier, 1943: 81).¹⁷ As Dr. O.D. Skelton, then Under-Secretary of State for External Affairs, would observe in the Special Committee of the House of Commons on the *BNA Act* in 1935: “... the Dominion recognized the desirability ... of preventing any further provincial demands, and sought by consultation with the provinces and by utilizing the formal method of amendment, to give some degree of permanence to the arrangement” (Ollivier, 1943: 79).

While the words “final and unalterable settlement” were omitted from the final amendment to section 118 of the *BNA Act* (passed as the *Constitution Act, 1907*), as it stands today, the amendment caps the grants the federal government is permitted to make to each province outside the division of powers in sections 91 and 92. The maximum, based on population, is \$240,000 per year plus: “... a grant at the rate of eighty cents per head of the population of the province up to the number of five hundred thousand and at the rate of sixty cents per head of so much of the population as exceeds that number” (*Constitution Act, 1907*: section 1 (1)). Once again, the precise language of this amendment emphasizes the framers’ intent to restrict the scope of this federal spending power to the specific terms and conditions that were written into the Constitution. Having expressly provided for federal grants to the provinces in section 118 of the *BNA Act* (now amended as per the *Constitution Act, 1907*), Canada’s founding fathers intended that the subject matter would be exhausted.¹⁸

17 The British Parliament retained final authority over any amendments to Canada’s Constitution until it was repatriated in 1982.

18 This interpretation is supported by the old legal maxim which says, “*expressio unius est exclusio alterius*” or “the expression of one thing is the exclusion of another.” This maxim holds, notwithstanding section 1(7) of the *Constitution Act, 1907*, which provides that “Nothing in this Act shall affect the obligation of the Government of Canada to pay to any province any grant which is payable to that province, other than the existing grant for which the grant under this Act is substituted.” Far from suggesting a broad spending power, the additional grants implied by this section logically refer to the further grant to New Brunswick explicitly authorized by section 119 of the *BNA Act*, or any section 118 grants the federal government might have failed to pay.

This restriction is still a binding part of the “Constitution of Canada,” which is the “the supreme law of Canada” and includes the *BNA Act, 1867* and the *Constitution Act, 1907* as part of a schedule of Acts, orders, and amendments appended to the *Constitution Act, 1982*.¹⁹ Within this schedule of Acts and orders, only the *Constitution Act, 1907* provides a clear authority for federal grants to the provinces. Additional grants—including payments in furtherance of a federal equalization scheme—may be made, but only pursuant to a constitutional amendment that explicitly provides for them notwithstanding the division of powers in sections 91 and 92 of the *BNA Act*.

The legality of the federal “spending power”

Despite the intended finality of the 1907 amendment to the “grant in aid” provision of the *BNA Act*, by 1935, as Skelton observed, “revision of the terms then granted ha[d] proceeded apace without formal amendments and without incidentally the consent of all of the provinces” (Ollivier, 1943: 79–82).²⁰ Today, the federal government operates under a host of statutes that it itself has enacted to exercise its spending power, including the *Federal-Provincial Fiscal Arrangements Act*, *Canada Health Act*, *Provincial Subsidies Act*, and many more. This federal “spending power,” while not defined in either the Constitution or any statute,²¹ has crept into use as “[t]he power of Parliament to make payments to people or institutions or governments for purposes on which it (Parliament) does not have the power to legislate” (Driedger, 1981: 124; see also Trudeau, 1969). The regularity of its use has prompted Thomas Courchene, one of the country’s foremost economists, to observe that “the magnitude and nature of intergovernmental cash and tax transfers [are] essentially *de facto* redistributions of power under the Constitution” (Courchene, 1985: 4).²²

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- 19 *Constitution Act, 1982*, section 52. The complete schedule of Acts, orders, and amendments can be reviewed at <http://lois.justice.gc.ca/en/const/sched_e.html>.
- 20 Skelton recounts the observations of Mr. J.A. Maxwell that “in the sixty odd years since 1869 there have been three general revisions scaling up the grants given to all the provinces and more than a score of special revisions affecting every one. Despite heavy withdrawals from capital account (*i.e.* debt allowances) the four original provinces in 1928-1929 drew more than three and one-half times as much from the federal treasury as had been promised in the *BNA Act*” (Ollivier, 1943: 82).
- 21 Driedger observed: “I have been unable to find the expression “spending power” in any Canadian judicial decision or statute” (Driedger, 1981: 124).
- 22 Illegal practice—even if it was adopted by governments and engaged in for years—cannot make the practice legal. That this cannot be the law is laid down in the most recent edition of *Halsbury’s Laws of England*, (4th): “A usage must be legal. No usage however extensive will

Arguably, this has done nothing to enhance the federal nature of Canada as a country. As observed by Andrew Petter (1989), now Dean of Law at the University of Victoria, the federal spending power runs counter to the principles of federalism insofar as it lets national majorities override regional majorities in dictating social and economic priorities. In addition, this power makes it difficult for citizens to attribute political responsibility to one or the other level of government, thus breaking the thread of accountability required for responsible government—a core convention of Canada’s parliamentary system.

For years, Canada’s courts were careful to guard against this *de facto* redistribution of power. There are a number of early historical examples whereby Canadian courts and legislators alike recognized the constitutional limits on the federal government and the perils of deviating from the constitution (for example, *Bank of Toronto v. Lambe* (1887); *Caron v. R.* [1924]; *Re: the Insurance Act of Canada* (1932)). The definitive precedents on the legality of federal grants to the provinces came from a series of Privy Council judgments in the so-called “New Deal” cases.

In 1935, the federal Parliament enacted a number of statutes modeled after US President Franklin Delano Roosevelt’s “New Deal” of unemployment insurance and closer regulation of working conditions, including limitations to hours worked and mandatory minimum wages. These statutes were enacted to implement draft conventions adopted by the international labour organization of the League of Nations in accordance with the labour part of the *Treaty of Versailles, 1919*. While the treaty had been ratified by the federal government, the Privy Council held that all of these statutes were beyond the powers of Parliament because each was related to matters reserved to the jurisdiction of the provinces by the *BNA Act*. The Privy Council said: “... the Dominion cannot merely by making promises to foreign countries, clothe itself with legislative authority inconsistent with the Constitution which gave it birth ... While the ship of state now sails on larger ventures and into foreign waters, she still retains the water-tight compartments which are an essential part of her original structure” (*Labour Conventions Case* [1937]).

The reference to “water-tight compartments” refers to the provisions of the *BNA Act* that made Canada a federal state. These provisions were intended to prevent the federal government on the one hand, and the legislatures of the

be allowed to prevail if it is directly opposed to positive law which for this purpose includes such universal usages as having been sanctioned by the courts have become by that adoption part of the common law, for to give effect to a usage which involves a defiance of law would be obviously contrary to fundamental principle.” Even if the practice were considered a constitutional convention, it would be unenforceable by a court of law (see footnote 5).

provinces on the other, from trespassing on each others assigned areas of jurisdiction.²³ The *BNA Act*, including sections 91 and 92, remain an essential part of Canada's Constitution and can only be changed by lawful amendment.²⁴

The related *Unemployment Insurance Case* [1937] prompted such an amendment. In this case, the Privy Council held that the federal legislation that provided for a system of compulsory unemployment insurance throughout Canada was beyond the powers of Parliament because it concerned property and civil rights, assigned by section 92(13) of the *BNA Act* to the exclusive legislative jurisdiction of the provinces. In the words of the Court: "If on the true view of the legislation it is found that in reality in pith and substance the legislation invades civil rights within the Province, or in respect of other classes of subjects otherwise encroaches upon the provincial field, the legislation will be invalid" (*Unemployment Insurance Case* [1937]). As a result of this judgment, a constitutional amendment (now section 91(2A) of the Constitution) had to be passed before Parliament could proceed with its plan for unemployment insurance.²⁵

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- 23 Over the years there have been a number of law professors and some judges who have expressed dissatisfaction with the division of powers specified in the *BNA Act* and have argued that the Privy Council's water-tight compartment statement should be regarded as narrow and inflexible and should no longer be applied (for further discussion of these criticisms see Cairns, 1971). The answer to that is that the *BNA Act* was the Constitution of Canada in 1867 and it remains part of the current Constitution. In addition, the water-tight compartment statement is a statement of the law laid down by the highest court of appeal for Canada. The Privy Council judgments upholding this clear division of powers have not been altered explicitly by legislation, constitutional amendment or subsequent judicial decisions (Yudin, 2002). Its effect could have been mitigated or obliterated in the process leading up to the repatriation of the Canadian Constitution in 1982 but it was not.
- 24 In contrast to the view of federalism as consisting in "water-tight compartments," supporters of a "progressive" approach to interpreting the Constitution cite Lord Sankey's celebrated opinion in the 1930 *Persons Case* that "The British North America Act planted in Canada a living tree capable of growth and expansion within its natural limits." This was not intended to undermine the sharp division of powers afforded either level of government in sections 91 and 92 of the *BNA Act*. Sankey added: "Their Lordships do not conceive it to be the duty of this Board—it is certainly not their desire—to cut down the provisions of the Act by a narrow and technical construction, but rather to give it a large and liberal interpretation so that the Dominion to a great extent, but within certain fixed limits, may be mistress in her own house, as the Provinces to a great extent, but within certain fixed limits, are mistresses in theirs" (emphasis added).
- 25 A similar amendment was required prior to the introduction of an old-age pension scheme in 1951 (section 94A).

This amendment would not have been necessary if statutes passed in the purported exercise of the federal spending power (such as the *Federal-Provincial Fiscal Arrangements Act* that enables the equalization program) were valid federal legislation. Accordingly, any other federal-provincial transfer program (and its enabling legislation) that uses federal tax revenues for provincial purposes—including equalization payments now granted under the *Federal-Provincial Fiscal Arrangements Act*—should be held illegal unless and until the Canadian Constitution is amended to provide for them.²⁶ Section 36, which stipulates Canada’s commitment to equalization will be fulfilled “without altering the legislative authority of Parliament or of the provincial legislatures” does not constitute such an amendment.

Recent challenges

The validity of the federal spending power has been alluded to by the Supreme Court of Canada but never fully debated or examined. A key reason for this is that the provinces (with the notable exception of Quebec) have seldom objected to—and, indeed, frequently encouraged—the use of the federal spending power to increase transfers for education, health, and other social programs. Unfortunately, by trading in their fiscal and policy autonomy for greater revenue, sub-national governments find themselves in what Professors Maite Careaga and Barry Weingast of Stanford University have called “fiscal pacts with the devil” that “benefit politicians, who gain more revenue to distribute according to political criteria, but harm citizen welfare” by favouring corruption and rent-seeking over public goods that foster growth (Careaga and Weingast, 2000: 4).

As a result of these political incentives, it took a private citizen, not a provincial government, to launch the first and only constitutional challenge of the federal spending power. In 1988, a taxpayer initiated a challenge of the constitutionality of the *Federal Income Tax Act* (*Winterhaven Stables Ltd. v. The Attorney General of Canada*, (1988)). The reason for the taxpayer’s complaint was that a portion of the monies extracted from him under the *Income Tax Act* were being transferred under federal statutes to the provinces to fund provincial programs in health, welfare, and post-secondary education, all matters within provincial legislative jurisdiction.

26 While beyond the scope of this discussion, all federal transfers and related legislation, from the Canada Health Transfer (CHT) and *Canada Health Act* to the Canada Social Transfer (CST) that support provincial welfare, education, and child-care spending would fail this test, whether granted conditionally (as is the CHT) or unconditionally. This serious constitutional challenge to the federal spending power will be dealt with at length in a study to be published by The Fraser Institute in early 2007.

There seems to have been no dispute about the facts and the trial judge explicitly found that the federal government was raising money through federal taxes that was then used for provincial purposes. Nevertheless, the Alberta Court of Appeal seemed unaware of the Privy Council precedents and upheld the legality of the federal provincial grants at issue, concluding that the impugned legislation (i.e. the *Income Tax Act* and the federal statutes authorizing the grants) did not constitute legislation “in relation to provincial matters.” The taxpayers’ case was refused leave to appeal to the Supreme Court of Canada,²⁷ leaving the matter open to future challenge.²⁸

Can federal transfers be unilaterally reduced?

While the Supreme Court of Canada has never been directly asked to consider the constitutionality of the federal spending power, in the 1990s it was asked whether the federal power to *reduce* grants made to the provinces infringed provincial jurisdiction. The reference case was initiated when British Columbia challenged the constitutionality of cuts to federal transfers for provincial social spending made under the 1966 *Canada Assistance Plan* (CAP). As part of a broad plan to reduce expenditures and, thereby, the federal budget deficit, Parliament had enacted a statute that amended the CAP to reduce the amounts payable by the federal government to provinces not eligible for equalization payments.²⁹

The Supreme Court of Canada upheld the ability of the federal government to reduce its payments to the provinces (*CAP Reference* [1991]). Relying on the long-standing principle of Parliamentary sovereignty, the Court held that no one, including Parliament itself, could prevent Parliament from repealing or amending legislation it itself had enacted.³⁰ While Manitoba

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- 27 The Supreme Court exercises broad discretionary power to set its own agenda and determine the cases it wishes to hear. Not granting leave allows the lower court decisions to stand until overturned by a higher court.
- 28 Reviewing this case law, Quebec’s Commission on Fiscal Imbalance concluded: “The federal spending power ... is still not part of this Constitution, unless more weight is given to a decision of the Court of Appeal of Alberta than to all the precedents of the Privy Council and of the Supreme Court” (Quebec, Commission on Fiscal Imbalance, 2002: 16).
- 29 At the time, these provinces were British Columbia, Alberta, and Ontario. CAP (a federal statute) was repealed in 1995 and replaced by *The Federal-Provincial Fiscal Arrangements Act*, the statute under which equalizations payments as well as the Canada Health and Social Transfers (CHT and CST) are now made.
- 30 Lending further support to the principle of Parliamentary sovereignty, the Supreme Court cited section 42(1) of the *Interpretation Act*, applicable to the CAP and all federal statutes where no

attempted to argue that Parliament could interfere in the provincial arena by enacting the CAP but could not then repeal or amend it, the Court concluded that “[t]he simple withholding of federal money which had previously been granted to fund a matter within provincial jurisdiction does not amount to the regulation of that matter.”³¹

Relevance to equalization

This prompts two observations that are directly relevant to the legality of equalization. First, if by providing money to provinces for purposes reserved to their original jurisdiction the *Canada Assistance Plan* was beyond the authority of Parliament under the *BNA Act*, then the CAP was invalid when enacted in 1966, and would still be invalid in 1991 when the case reached the Supreme Court of Canada. The validity of the amendment reducing payments made under CAP would be moot or irrelevant. The same logic holds true for equalization: if the federal transfer program was beyond the powers of Parliament when first initiated, it would also be invalid when the equalization commitment was drafted into the *Constitution Act, 1982*.

Second, the provisions of sections 91 and 92 of the *BNA Act* do not divide jurisdiction between the federal government and the provincial legislatures on the basis of the “regulation” of subject matter. The dividing line is whether or not a law is “in relation to” subject matters reserved exclusively to Parliament or reserved exclusively to the provincial legislatures. Even if federal equalization grants do not amount to regulation of the public services falling within provincial jurisdiction, they are most certainly granted “in relation” to these provincial matters, and as such run afoul the Constitution. The constitutionality of any changes or reductions to these payments would be irrelevant because the payments themselves would have been invalid. Because the Supreme Court disposed of the *CAP Reference* on the issue of Parliamentary sovereignty alone and failed to consider the broader constitutionality of the federal spending power, the matter remains open to future challenge.

contrary intention appears: “Every Act shall be so construed as to reserve to Parliament the power of repealing or amending it, and of revoking, restricting or modifying any power, privilege or advantage thereby vested in or granted to any person” (*CAP Reference* [1991], at p. 29).

³¹ As indicated, the basis for the decision of the Supreme Court of Canada in the *CAP Reference* was Parliamentary sovereignty, and this additional comment is of the sort known in law as “*obiter dicta*.” While technically judges deciding cases in the future are entitled to look at *obiter dicta* but not obliged to follow them, the Supreme Court of Canada has purported to lay it down that anything the Supreme Court of Canada says whether *obiter* or not is to be followed by all other courts in Canada (*R. V. Henry* [2005], at para 638).

Conclusion

The assumptions concerning the legal requirements of equalization made in the past do not stand up to scrutiny for two key reasons. First, insofar as the Constitution's equalization provisions represent a vague expression of political goals, constitutional scholars are in broad agreement that they cannot be enforced by a court of law. How these political goals are to be achieved is left entirely to the discretion of Parliament and the legislatures; should these political actors reach an impasse in their negotiations, the Constitution provides no guide as to what level of public services, taxes, or equalization payments might be "reasonable," "comparable," or "sufficient." Second—and more fundamentally—because equalization uses federal tax revenues to fund spending in areas of exclusive provincial jurisdiction, the entire equalization program falls beyond the powers of Parliament as defined by Canada's founding Constitution, the *British North America Act, 1867 (BNA Act)*. While beyond the scope of this discussion, this has serious implications for other federal-provincial transfer programs.

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Assessing the pre-2004 equalization program

Kumi Harischandra and Niels Veldhuis

Prior to the introduction of the New Framework for equalization and side agreements in 2004,¹ which effectively ended the previous rules-based system of equalization, there was increasing consensus that serious problems existed in the equalization program. Even before the collapse of the old system in 2004, there was growing recognition that equalization faced marked difficulties.

This chapter summarizes a number of studies that have examined equalization including a watershed study by Professor Dan Usher of Queen's University (1995). These evaluations should aid readers both in understanding problems in the past as well as in formulating suggestions for reforms for the future.

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- 1 The New Framework for equalization was introduced in 2004 and scheduled to take effect in 2005/06 (last fiscal year). Instead of relying on a clearly defined formula to calculate the total cost of equalization as well as the individual provincial payments, the New Framework established a fixed pool of funds for 2005/06 at \$10.9 billion. This pool was set to grow at an annual rate of 3.5%. In addition, the federal government also entered into a number of high-profile side agreements with certain provinces. The Offshore Agreements with Newfoundland and Nova Scotia insulated these provinces from reductions in equalization payments due to offshore energy revenues. Additional side agreements were also made with Saskatchewan and Ontario on other issues.

Usher: *The Uneasy Case for Equalization Payments*

In his comprehensive book, *The Uneasy Case for Equalization Payments* (1995), Professor Usher assessed the existing equalization program based on the criteria of equality, efficiency, and equity.² Professor Usher concluded that the case for equalization remained unproven on all three criteria.

Equality

In principle, equality dictates a narrowing of the distribution of income in a jurisdiction, closing the gap between the rich and poor. By transferring federal funds collected from various sources of federal taxation (income tax, corporate tax, GST) to the “have-not” provinces, equalization can theoretically close this gap by enabling provincial governments to lower provincial taxes and allow people to enjoy greater after-tax income. Alternatively, direct transfers to individuals funded by equalization payments could also create greater equality. However, the program does not specify how the funds are to be distributed within the provinces or who the ultimate beneficiaries would be. Professor Usher’s assessment of equalization on the grounds of equality was based on the following five factors: (1) impact on the distribution of income; (2) anti-redistributive bias; (3) effect on progressive taxes; (4) distribution of tax bases; and (5) impact on migration.

1 Impact on the distribution of income

Professor Usher considered several possibilities in the context of equalization payments to analyze the outcomes on the distribution of income,³ two of which are considered here. If, for example, equalization results in the transfer of funds from rich people in rich provinces to poor people in poor provinces, the objective of equality would be achieved. On the other hand, it might be the case that the transfers flow from rich people in rich provinces to rich people in poor provinces with little benefit accruing to the poor. Under such circumstances, Professor Usher believed that a direct transfer to the poor targeted to alleviate poverty may promote greater equality compared to a system of equalization payments. Using these and other

2 These criteria are important in the assessment of public policy and used often by economists because they embody the objectives of narrowing the gap between rich and poor (equality), creating national prosperity (efficiency), and adherence to the customs of society that ensure harmony and fairness (equity).

3 The distribution of income represents the proportion of a population at various income levels for an occupation, industry, province, or country.

examples, Professor Usher argued that it is extremely difficult to assess the impact of the program on the distribution of income.

2 Anti-redistributive bias

There is a basic conflict between the rich and the poor in any society. Typically, the rich want fewer government transfers benefiting the poor (less redistribution) whereas the poor desire more transfers (more redistribution). Professor Usher argued that the “antiredistributive bias” in a federation⁴ goes over and above this basic conflict. In a federation, the rich oppose redistribution more vigorously than they would in a unitary state⁵ because redistribution causes the poor to immigrate, and the rich to emigrate, within the federation: a province in a federation with a reputation for generosity would attract poor people who may wish to become welfare recipients and provinces with less redistribution would attract the rich. Hence, the rich have a double incentive to oppose redistribution in a federation.

Professor Usher noted that equalization may help to dampen but not entirely eliminate the antiredistributive bias in a federation. The bias held by the rich against redistribution to the poor might be dampened if a province uses equalization payments to fund transfers to the poor. However, Professor Usher pointed out that equalization is not a substitute for a nation-wide redistribution program, especially since the program does not specify the use of funds for recipient provinces.

3 Effect on progressive taxes

Equalization is essentially a transfer from the federal government to provincial governments and must be funded out of federal taxation (*e.g.* federal income tax, GST). The equalization program might increase federal taxes in order to raise sufficient revenue to fund the program, with the increase in federal taxes borne by residents in all provinces. On the other hand, provincial taxes for residents in provinces receiving equalization might decrease as these provincial governments might be able to reduce provincial taxes and yet have sufficient revenues to fund public services since equalization payments would cover the shortfall. If, on the whole, the decrease in provincial taxes (plus equalization transfers) is greater than the increase in federal taxes, residents of provinces receiving equalization will be better off in terms of higher after-tax incomes.

4 A federation is a country comprising a number of self-governing regions (or provinces in the case of Canada) united by a central government.

5 A unitary state is a single, self-governing, region.

The evaluation of equalization payments on the grounds of equality largely depends on whether federal taxes are more or less progressive than provincial taxes. A tax is progressive when the rich pay a higher proportion of their income in tax than the poor. If the revenue from progressive taxes are transferred to the poor in order to make them better off, redistribution has occurred. If federal taxes are more progressive compared to provincial taxes, an increase in federal taxes may result in greater redistribution. Conversely, if provincial taxes are more progressive than federal taxation, a reduction of the former might make the poor worse off. Thus, several outcomes can arise depending on the tax mix. Professor Usher argued that with a complex tax system in place, the final effect of equalization on the poor is uncertain.

4 Distribution of tax bases

Tax bases form the basic foundation of the equalization formula. Their distribution, however, may not correspond with the distribution of income per person, a measure of economic well-being. Thus, a province that is rich in terms of per-capita income may be “poor” in terms of certain tax bases (*e.g.* resource revenues). This may lead to the perverse situation where, owing to a few below-average tax bases, a “have” province is classified as a “have-not” province and receives equalization payments. In such a situation, equalization might have the effect of transferring funds from a province where people are, on average, poor to a province where people are, on average, rich.

5 Impact on migration

A final consideration of equality is the program’s impact on migration. Theoretically, a key incentive for workers to migrate across provinces is to take advantage of better economic prospects. For instance, workers might immigrate to provinces where earnings are relatively high. The effects of migration are not confined to workers alone: they can potentially affect the earnings of other factors of production such as owners of land and capital since migration changes the composition of factors of production in a province. For example, if more workers migrate to a province, competition among them for jobs would enable employers to hire them at lower wages. At the same time, the higher supply of workers might cause employers to use more labour-intensive methods of production in some industries, affecting the earnings of the owners and producers of capital goods.

An equalization-receiving province providing attractive transfers to workers might attract workers from other provinces. However, the final effect of migration on provincial economies is extremely difficult to determine since it depends on a number of factors ranging from the skills composition of

the workers to the composition of the factors of production across provinces. Professor Usher argued that it is difficult to determine a clear outcome owing to the complexity of the analysis involved.

Conclusion

Professor Usher concluded that the case for equalization on the grounds of equality is uncertain due to a number of considerations outlined above. He further noted that alternatives to equalization such as the direct transfer of funds to alleviate poverty might go further along the road to equality compared to the equalization program.

Efficiency

Efficiency is achieved when a policy or program generates national prosperity as measured by National Income, the total value of goods and services produced in a country. Professor Usher identified and evaluated six efficiency considerations: (1) migration; (2) cost of collecting taxes; (3) spillovers; (4) national standards and provincial provision; (5) interprovincial insurance; and (6) administrative costs of implementing the program.

1 Migration

It is widely held that the equalization program promotes efficiency by correcting “distortions” in the economy arising from resource revenues,⁶ public goods, and overhead costs. A public good, as in the case of a television signal, provides benefits to all who consume it regardless of the number of beneficiaries. On the other hand, an overhead cost like public legislature, conveys no direct benefits to individuals but is required for the efficient functioning of a province. Distortions arise when workers are attracted to some provinces based on the availability of resource revenue transfers, better public goods, or lower overhead costs and not due to the availability of better work opportunities. Such distortions may result in a lower level of National Income in Canada as a whole than would otherwise be the case if migration solely depended upon the availability of better employment prospects.

In theory, this creates room for a program like equalization to correct the effects of inefficient migration. For instance, if workers in a resource-poor province were offered transfers funded by the equalization program, they may have less motivation to migrate to a resource-rich province. However, Professor Usher argued that the program may not fully repair the distortion.

6 These include revenues arising from the extraction and sale of renewable resources (forests, hydroelectric power) and non-renewable resources (oil, gas, minerals).

In other words, his concern was that the increase in National Income as a result of correcting the effects of inefficient migration might be small relative to the total cost of the equalization program.⁷

2 Cost of collecting taxes

Taxation imposes direct and indirect costs on taxpayers. The direct cost is the actual tax paid that allows governments to finance their spending. The indirect cost of taxation occurs when firms, workers, and consumers choose unproductive but untaxed activities (production, consumption) in favour of productive but taxed activities. Additionally, tax evasion by some people imposes a cost on others by increasing their tax payments to finance the same level of government spending. Equalization payments to poor provinces might be justified if the total cost (direct and indirect) of raising a given level of revenue is disproportionately higher for poor provinces than for rich provinces. In the absence of equalization, poor provinces would have to levy higher tax rates in order to finance the same level of public spending per person as richer provinces. With equalization, poor provinces and their residents could benefit from lower tax rates than would otherwise be the case without equalization but have the same level and quality of public services as a national average since equalization payouts would cover the shortfall.

Although this case for equalization is logically appealing, Professor Usher argued that it was uncertain for two reasons. First, there is no requirement on the part of recipient provinces to use equalization funds for increasing the level and quality of public services. Hence, it is uncertain whether equalization will improve public services. Secondly, it is extremely difficult to assess whether the equalization program indeed helps to reduce the costs of taxation for recipient provinces. The difficulty is compounded by the currently limited measures of the full costs of taxation.

3 Spillovers

Another argument for equalization is that provincial expenditures can produce “spillovers” or benefits to other provinces. For instance, provincial spending on health and education may result in healthy, educated workers who generate higher tax revenues (through higher incomes) to finance federal government spending that benefits other provinces. Professor Usher argued that spillovers do not necessarily follow upon equalization payments, especially since the program does not mandate provinces to use equalization

7 In fact, Professor Usher noted (1995: 72) that the only estimate available, by William G. Watson (1986), suggested that the ratio of efficiency gains to costs of the program was 1 to 500.

funds for specific activities. Instead, he suggested that a simpler strategy might be to provide direct subsidies or dollar-for-dollar matching grants towards the activity that generates the spillovers.

4 National standards and provincial provision

A popular case for equalization is based on its requiring national standards so that jurisdictions provide a minimum level of public services. An excellent example is the Canada Health Act's requiring adherence to national standards of medical care. Arguably, in the absence of equalization payments, poor provinces might be forced to levy high taxes in order to meet the national standard in the provision of public services. High taxes impose heavy costs on the economy in resources wasted in tax evasion and avoidance as well as the diversion of economic activities (production and consumption) to less productive but untaxed activities. These have adverse effects on provincial and national economies by reducing National Income.

In Canada, key public services such as medical care fall under the jurisdiction of provincial governments. Professor Usher argued that a likely reason for this arrangement in the context of national standards would be to allow provinces to respond to the local needs and preferences of their residents. With an equalization program in place, provinces can meet national standards, while at the same time providing service of a locally specific nature.

However, Professor Usher argued that, with the exception of Quebec, the need to consider local tastes and preferences appeared to be weak in Canada. He noted that if the maintenance of national standards was indeed driving the program, direct federal provision of such services or provincial provision with complete federal funding might be preferable.

5 Interprovincial insurance

The equalization program may be justified as a form of interprovincial insurance: provinces that are rich today provide assistance to poor provinces through the federal government, in the hope that such aid would be reciprocated in the future. However, according to Professor Usher, this is a not a convincing argument given that some of the contributors (Alberta and Ontario) today were contributors at the start of the program.

6 Administrative costs of the program

The overhead costs of the program from items such as negotiating equalization payments and resolving disputes that arise among the provinces may be substantially larger than those of other federal programs. One estimate of the administration costs of the equalization program stands at approximately \$5.0 million for 1994/95 (Usher, 1995: 147).

Other inefficiencies

Finally, the presence of equalization payments may also encourage provinces to maximize their receipts, leading to other inefficiencies: (1) recipient provinces have incentives to over-spend whereas non-recipient provinces have incentives to under-spend; (2) recipient provinces have incentives to increase tax rates on their deficit bases and (likewise lower tax rates on their surplus bases),⁸ and (3) all provinces have incentives to hide tax bases to appear “poor” in terms of such bases. When provinces compete for federal monies by choosing the most favourable tax mix for themselves while ignoring the effects on other provinces, it is costly for Canada as a whole.

Conclusion

Professor Usher concluded that the case for equalization on the grounds of efficiency remained inconclusive. Depending on the circumstances, he argued, the program may or may not generate economic prosperity in Canada.

Equity

Professor Usher defined equity as “an adherence to the customs of society” and “some principle of fairness, order, or good government” (Usher, 1995: 5, 95). He considered three major points that weakened the case for equalization as a vehicle for equity: (1) horizontal equity; (2) the tax-back problem; and (3) the federal government’s “spending power.”

1 Horizontal equity

The principle of horizontal equity in taxation requires that “equals should be taxed equally.” persons with similar incomes should be taxed similarly regardless of occupation (Usher, 1995: 98). Without horizontal equity guiding taxation, the whims and fancies of tax authorities would govern tax policy, leading to a proliferation of corrupt activities.

It is often claimed that the equalization program is an extension of the principle of horizontal equity: people ought to be provided the same levels and quality of public services at the same rates of taxation. However, Professor Usher argued that parallels cannot be easily drawn between the two since: (1) horizontal equity applies to *people* and may not be applicable to *provinces*; (2) equalization need not be the sole principle underlying federal-provincial relations; and (3) there is no specific rule or formula in the Constitution for determining the transfers.

8 A province has a deficit (surplus) base when a provincial tax base per person is lower (higher) than the national “standard,” qualifying the province for greater (lower) equalization payments on that base.

The first point concerns jurisdiction. Horizontal equity is violated if persons with the same incomes are taxed at different rates within the United Kingdom for example but not if persons with the same incomes are taxed at different rates in United Kingdom and Germany. Under the Canadian Constitution, provinces are identified as separate jurisdictions and the principle of horizontal equity may not apply to individuals across provinces.

Second, there is an alternative to equalization as a basis for defining federal-provincial relations: the principle that each province should finance public services with its own revenue. Professor Usher pointed out that other federations like the United States do not have a program of equalization but has alternative mechanisms for maintaining federal-provincial relations. Therefore, it is arguable whether equalization is indispensable for preserving this relationship.

Thirdly, section 36(2), which requires provinces to “have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation” does not translate indisputably into “equal revenues for all provinces at equal rates of taxation” (for further details, see Usher, 1995: 104). The interpretation of the constitutional mandate is open to debate and provinces can always find grounds for lobbying the federal government for higher entitlements.

2 The tax-back problem

When any recipient province has a disproportionate share of a tax base or resource (e.g. asbestos in Quebec, potash in Saskatchewan), raising the tax rate on this particular base will increase provincial revenue and correspondingly reduce its equalization payments. Hence, recipient provinces would have strong incentives to reduce tax rates on surplus bases in the hopes that equalization payments will compensate them for the loss in revenues. Due to this problem, the federal government introduced the Generic Solution whereby, if a recipient province has at least 70% of the national tax base subject to equalization, only 70% of the revenues will be considered for the purpose of the equalization calculations. In other words, provinces are guaranteed retention of 30% of their resource revenues, creating a buffer against a loss in entitlements on large resource bases. Professor Usher argued that these rates (e.g. 70%) are arbitrarily determined and subject to ad-hoc adjustments and provisions upon negotiation with the federal government.⁹

9 In fact, the side agreements with Newfoundland and Labrador and with Nova Scotia enacted in 2004 to insulate these provinces from losses in equalization payments arising from their offshore resource revenues demonstrate the ad-hoc nature of adjustments to equalization.

3 The federal government's "spending power"

Although the Canadian Constitution does not allow the federal government to spend directly within provincial jurisdictions, Ottawa could indirectly influence the activities of the provinces through exercising its "spending power," an elaborate system of transfers from the federal government to provinces. Equalization payments can become a manifestation of the federal government's spending power. This naturally leads to unhealthy competition among provinces, each seeking to maximize its share of federal bounty through equalization entitlements.

Conclusion

As he did in his analysis for equality and efficiency, Professor Usher argued that there is no conclusive evidence supporting the claim that equalization promotes equity. The above considerations demonstrate that the case for equalization as a vehicle for equity is ambiguous.

Professor Usher's conclusion

The claim that the equalization program unambiguously promotes equality, efficiency, and equity remains unproven. By identifying and analyzing possible effects of the program, Professor Usher concluded that the equalization program may or may not achieve these objectives.

Courchene: Tax-back rates and the case of Saskatchewan

The problem of tax-back rates has been a widely documented issue in the equalization debate and deserves special mention here. Under pre-2004 equalization arrangements, an increase in a province's revenue resulted in a dollar-for-dollar reduction in equalization payments. This arrangement, called the tax-back problem, became particularly contentious in the presence of resource revenues. A province that attempted to realize its resource potential by investing in resource development experiences a loss in equalization payments dollar-for-dollar with an increase in resource revenues. Moreover, the tax-back problem for resource revenues was not applied equitably to all provinces.

In *Confiscatory Equalization: The Intriguing Case of Saskatchewan's Vanishing Energy Revenues* (2004), Professor Thomas Courchene of Queen's University provided a detailed analysis of the tax-back problem with particular reference to the province of Saskatchewan. According to Professor Courchene's analysis, Saskatchewan experienced an increase in energy revenues of \$668 million but faced a subsequent decline in equalization payments equivalent to \$835 million

over the period from 1998 to 2001. This resulted in a confiscatory tax-back rate of 125%. The decline was based on the assessment that Saskatchewan's revenue-raising (fiscal) capacity had increased owing to its resource revenues. Nova Scotia and Newfoundland, on the other hand, benefit from special provisions under the Offshore Agreements to prevent reductions in equalization owing to their offshore resource revenues. The contrasting treatment of provinces with respect to the tax-back issue causes serious equity and efficiency problems.

Saskatchewan's experience is inequitable. Professor Courchene maintained that the unequal treatment of Saskatchewan and the Maritime Provinces violates the principle of equity. He also argued that this unequal treatment was inefficient and may have negative effects on Saskatchewan's economy by triggering an out-migration of workers to other provinces in addition to creating great disincentives for developing a billion-dollar energy industry in the province. Professor Courchene pointed out that, in fact, the tax-back problem may partially account for Saskatchewan's recent dramatic decline in per-capita, after-tax income.

Professor Courchene identified three major reasons that might account for the unusually high tax-back rates: (1) a shift in calculation of standards; (2) the Generic Solution; and (3) artificial tax rates and tax bases.

1 Shift in calculation of standards

Since its inception, equalization has been based on a formula that used average tax rates and tax bases. Under the existing equalization system, a "standard" tax base is used to assess whether a province's tax base per person is below average for each of 33 revenue categories. The "standards" themselves are defined as average tax bases across all or selected provinces for each revenue category. Essentially, a province qualifies for equalization if most of its tax bases per person are below average compared to the "standard" bases.

In 1982, there was a shift in the calculation of standards from a national average standard (NAS) to a five-province standard (FPS). The NAS was simply a ten-province average whereas the FPS was the average of five selected provinces: Quebec, Ontario, Manitoba, Saskatchewan, and British Columbia. Since Alberta was excluded from the FPS, Saskatchewan's share of energy bases increased significantly relative to other provinces in the FPS. In other words, Saskatchewan's tax bases per person for certain resource revenues were considered as above average compared to FPS standards although this was not the case when calculated under NAS standards. Hence, Saskatchewan was assessed as having an above-average share of resource revenues with the result that its equalization payments declined. Courchene argued that this assessment did not reflect Saskatchewan's true

revenue-raising ability in terms of resource revenues since the assessment depended heavily upon the choice of standards.

2 The Generic Solution

The Generic Solution ensures that, if a province has at least 70% or more of a tax base in Canada as a whole, only 70% of the revenues from that base will be included in the equalization calculations. Saskatchewan does not qualify for the Generic Solution for energy resource bases since it does not account for 70% of the energy-tax bases in Canada, although it accounts for over 70% of many energy bases within the five provinces on which the FPS is based. Hence, the federal government does not allow Saskatchewan to qualify for the same privileges accorded to Nova Scotia and Newfoundland. In the latter cases, the federal government created special energy categories for the off-shore oil bases of these provinces so that they accounted for 70% or more of the national tax bases and their maximum tax-back rate was capped at 70%.

3 Artificial tax rates and tax bases

Professor Courchene argued that some tax rates and bases have been artificially created by the equalization authorities (the federal government), distorting measures of Saskatchewan's revenue-raising capabilities. An example often cited is the treatment of the Sales of Crown Leases, a revenue category. The authorities set the national tax rate for the Sales of Crown Leases at 15.6%. Since Saskatchewan appeared to be under-taxing Crown leases at 6.9% according to the authorities' own calculations, a penalty tax-back rate of over 200% was imposed on this revenue base for the province.

Conclusion

Professor Courchene used Saskatchewan as an example to highlight the undesirable effects upon equity and efficiency that arise from the tax-back problem in the equalization program. In order to remedy these effects, Professor Courchene proposed a series of recommendations for the treatment of resource revenues. These are examined in chapter four of this book.

Feehan: Treatment of resource revenues

The treatment of resource revenues has been a critical issue in the equalization debate. Professor James Feehan of Memorial University provided an in-depth analysis of this issue in his contribution (Feehan, 2005) to the volume on Canadian fiscal arrangements edited by Harvey Lazar (2005). Professor

Feehan identified instances of inefficiency and lack of equity arising from the existing equalization arrangements and argued that reforms to the treatment of resource revenues under the equalization program should be a priority.

Efficiency

Professor Feehan essentially reiterated the conclusion of the Economic Council of Canada (1982) that provinces are currently under-collecting resource revenues, which reduces the national average royalty rates (tax rate) for resources. He concluded that they do because resource revenues lead to a dollar-for-dollar reduction in equalization. Provincial governments are under-pricing the true value of their resource revenues in order to prevent claw-backs of equalization payments.

Professor Feehan identified a number of associated problems arising from the under-collection of resource revenues. For example, the consequence of under-pricing a scarce resource is over-consumption of the resource. Moreover, he argued that it sent misleading signals to the market, leading to misallocations of labour and capital that affected productivity. He also argued that provinces had less incentive to develop natural resources that would generate future resource revenues rather than engage in other endeavours.

Although the federal government has recognized these efficiencies, only partial remedies have been adopted. Indeed, some of these remedies (e.g. Offshore Agreements) may impinge on equity considerations discussed below. Hence, Professor Feehan stressed that propositions enacted to restore efficiency should also integrate equity issues.

Equity

Equity in equalization requires fair treatment of all provinces involved. Perhaps the strongest equity concern expressed by Professor Feehan is the conflict between two constitutional provisions: the Equalization program and section 125 of the Constitution Act of 1982 that prohibits the two levels of government from taxing one another. Despite these provisions, the widely documented phenomenon of the tax-back rate has demonstrated that provincial governments in fact “lose” their resource revenues to the federal government through a dollar-for-dollar reduction in equalization entitlements.

Conclusion

Professor Feehan concluded that the existing equalization arrangements for resource revenues have created pressing equity and efficiency issues. He called for a reformulation of resource equalization. These are reviewed in chapter four of this book.

Atlantic Institute for Market Studies (AIMS)

The Atlantic Institute for Market Studies (AIMS) has published a number of volumes on equalization. Some of these examine concerns about the efficiency and equity of the equalization program that are reviewed elsewhere in this chapter.¹⁰ There are also a number of other issues identified by the AIMS authors; three of the more important are: (1) fiscal imbalance; (2) federal transfers and Atlantic Canada; and (3) the “flypaper effect.”

1 *Fiscal imbalance*

In *Too Many Cooks: National Purpose and Equalization* (2006), Robin Neill, AIMS Chairman of the Board of Research Advisors and Adjunct Professor of Economics at the University of Prince Edward Island and Carleton University, pointed out that one of the inefficiencies produced by the current equalization system entailed a “fiscal imbalance” occurring when “one government taxes and another government spends the revenue generated by the tax” (Neill, 2006: 4).¹¹ Essentially, this means that the government responsible for levying the taxes required to fund equalization transfers (the federal government) is not responsible for spending the transfers (provincial governments). Professor Neill theorized that when responsibilities in taxing and spending lie with different governments, efficiency might be compromised: since provincial governments do not assess the total cost of funding the equalization program (because that responsibility lies with the federal government), it is unlikely that they would choose the most efficient uses of the funds. In order to redress the fiscal imbalance and other inefficiencies of the existing equalization program, Professor Neill proposed a system of provincially differentiated transfers that will be discussed in greater detail in Chapter 4, *Equalization Reforms*.

10 These AIMS publications include, among others, Boessenkool (2001, 2002a, 2002b), Buchanan (2002), Crowley (2002), Crowley and McIver (2004), Crowley and O’Keefe (2006a, 2006b, 2006c), Dahlby (2002), Martin (2001), McMahon (1996, 2000), Winchester (2005).

11 Professor Neill’s use of the term “fiscal imbalance” differs from that used by the Council of the Federation’s Advisory Panel in their report. The Advisory Panel recognizes both “horizontal fiscal imbalance,” a disparity in the capacity of provinces to raise the revenues required to provide a given level of public services and “vertical fiscal imbalance,” a disparity between the revenue raising-abilities of the federal and provincial governments as compared to their spending requirements (see chap. 4: 75–78).

2 Federal transfers and Atlantic Canada

In *The Perils of Being a Poor Region in a Rich and Frightened Country* (2005), Brian Lee Crowley, President of AIMS, presented a comprehensive critique outlining the impact of equalization and other federal transfers on the economies of Atlantic Canada. He argued that “massive federal intervention” in the form of federal transfers were largely responsible for the failure of Atlantic Canadian economies to “catch up” with the rest of the country (Crowley, 2005: 1). He pointed out that, while federal programs such as employment insurance, equalization, and regional development initiatives were originally designed to improve economic growth in the region, they had instead created a web of dependency.

Crowley emphasized that equalization encouraged bad policies on the part of the governments of recipient provinces. Instead of implementing policies that would boost economic growth, provincial governments of recipient provinces chose policies that entitled them to more equalization payments. For instance, equalization created incentives for provincial governments to manipulate tax rates to increase equalization payments. It also provided little or no incentives for provincial governments to reduce government debt. Crowley noted that the typical outcome of these activities were higher taxes, higher levels of debt, and continual lobbying with the federal government to increase transfers. Essentially, he argued that equalization changed the behaviour of provinces receiving equalization and their residents, encouraging them to abandon sound economic policies that would generate prosperity and growth in favour of a sustained stream of transfers.

3 The “flypaper effect”

In a recent AIMS commentary on equalization, *The Flypaper Effect* (2006b), AIMS President Brian Lee Crowley and policy analyst Bobby O’Keefe found that provinces receiving equalization had higher than average levels of public-service employment, public-sector wages, and provincial debt. They argued that equalization may be encouraging the governments of recipient provinces to spend excessive amounts on the public sector instead of improving the levels and quality of public services. If this is indeed the case, they argued, equalization should be streamlined to achieve the original goals of the program at a lower cost

Conclusion

In the past, many AIMS authors on equalization have reiterated concerns expressed by other experts on the topic. More recent criticisms of equalization by AIMS researchers have highlighted the program’s serious disincentive effects

on the economies of Atlantic Canada, the creation of a “fiscal imbalance,” and the likely effects of the program on the size of provincial public sectors.

Boothe: *Simply Sharing*

In *Simply Sharing: An Interprovincial Equalization Scheme for Canada* (Boothe and Hermanutz, 1999) Professor Paul Boothe and Derek Hermanutz echoed many of the concerns identified by Professor Usher. However, their analysis was broader since they considered the impact of key federal transfer programs (specifically the Canada Health and Social Transfer (CHST) program)¹² and the regional component of the Employment Insurance (EI) program as well as equalization. Boothe and Hermanutz identified the following key issues arising from federal transfers in general: (1) equity; (2) migration; (3) behaviour of provincial governments; and (4) transparency and accountability.

1 Equity

Professor Boothe and Mr Hermanutz argued that, while federal transfers might make provincial governments better off, they might make individuals worse off. Because federal transfers are ultimately financed out of federal taxes, the overall effect of the transfers may worsen the financial situation of poor Canadians for whose welfare the transfers were originally designed. For instance, if poor Canadians pay more in federal taxes than they are compensated for by federal transfers, they will be made worse off. In fact, there is some evidence that federal programs (equalization, CHST, and the regional component of EI) on the whole transfer income from poor Canadians in rich provinces to rich Canadians in poor provinces.¹³ This is both undesirable and contrary to the objective of federal transfers, particularly equalization, which should ideally transfer income from rich Canadians in rich provinces to poor Canadians in poor provinces

2 Migration

The effect of equalization upon interprovincial migration has been widely discussed but other federal transfers, particularly to economically poor regions,

12 The Canada Health and Social Transfer (CHST) program was a predecessor of the current Canada Health Transfer (CST) and Canada Social Transfer (CST) programs.

13 For example, Finn Poschmann (1998) found that an Alberta family with an income between \$30,000 and \$40,000 contributed 9% to federal programs in 1997 while a Newfoundland family earning over \$100,000 received benefits equivalent to 1.2% of their income.

might also hinder people from migrating to regions with better employment prospects. Because they receive generous benefits financed out of federal transfers, workers might choose to remain in regions with high unemployment rather than move to areas with plentiful jobs. For this reason, regional differences in Employment Insurance especially have been criticized because it tends to dampen incentives for workers to migrate to regions with greater employment opportunities.

3 Behaviour of provincial governments

Transfers may discourage provincial governments from engaging in beneficial economic activities. A widely documented example is the “tax-back” problem in the equalization program where provincial governments lose equalization payments dollar for dollar when their own revenues from a tax base increase. The “tax-back” problem may result in governments discouraging the very activity that generates greater own-source revenues because any additional revenue will be “clawed back” through a reduction in equalization payments. Additionally, Professor Boothe and Hermanutz pointed out that there is evidence that provincial governments increase tax rates on certain tax bases in an attempt to increase equalization payouts.¹⁴ Under the pre-2004 equalization program, provincial governments could manipulate the amounts received under the program by adjusting tax rates on some of their tax bases.

4 Transparency and accountability

Professor Boothe and Hermanutz argued that the extreme complexity of the current system of federal transfers prevents an open and transparent evaluation of the program. They noted that only a few policy experts in the government and academia understand the complete workings of the existing transfer system and argued that the complexity of the system had created a false sense of precision in the calculations.

A further issue lies in allocating accountability. Since all federal programs are eventually financed out of federal taxes, a part of the transfers that provinces receive are financed out of their own residents’ tax dollars. Professor Boothe and Hermanutz argued that netting out federal taxes collected in a province against federal transfers received provides a clearer picture of the actual flow of federal funds to a province.¹⁵ They stressed that considering

¹⁴ See Michael Smart’s (1998) work on equalization’s effect on provincial tax rates.

¹⁵ The authors noted, for instance, that a study by Frank and Hermanutz (1997) showed that, of the \$8.7 billion transferred via the equalization program in 1995/96, only \$5.8 billion was actually transferred from contributing provinces to receiving provinces.

the total value of transfers, instead of net transfers, hinders voters from designating accountability in the use of funds to specific governments.

Conclusion

In sum, the analysis by Professor Boothe and Hermanutz indicates that key federal transfer programs such as equalization, employment insurance, and CHST may have undesirable effects upon efficiency and equity. They also point out that the complexity of federal transfers create serious problems in terms of transparency and accountability.

Conclusion: Key problems with the equalization program

This chapter has reviewed some of the key problems with the pre-2004 equalization program identified by leading academics and policy analysts. Professor Usher concluded that the program may or may not achieve the goals of equality, efficiency, and equity. Professor Feehan identified efficiency and equity concerns specific to the treatment of resource revenues. An assessment of resource equalization and the tax-back rate by Professor Courchene also reiterated the underlying inequity in the treatment of resource revenues for different provinces. A number of AIMS authors have also addressed issues like federal transfers to Atlantic Canada and the “flypaper effect” that arise from equalization. Finally, Professor Boothe and Derek Hermanutz demonstrated that other federal transfer programs have problems similar to those of the equalization program.

The arguments reviewed in this chapter point the reader in one direction: there appears to be serious problems with the equalization program that require immediate attention. Given this assessment, there is increasing consensus within both policy circles and the federal and provincial governments for a re-formulation of the program in order to rectify these and other problems.

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Equalization reforms

A review of prominent proposals

Jason Clemens and Kumi Harischandra

Prior to the implementation of the New Framework for equalization, there were increasing calls for reforms to the program.¹ The New Framework and several high-profile side agreements² effectively undermined the foundation of the equalization program by abandoning the formula used to determine both the total cost of the program and provincial equalization payments. In response, both the Council of the Federation (a collaborative body whose members are the governments of the 10 provinces and the three territories of Canada³) and the federal government undertook major reviews of the program with the goal of re-establishing a functioning equalization system. In this chapter, we provide a summary of the reports of both the federal government's Expert Panel on Equalization and Territorial Formula Financing (2006) and the Council of the Federation (2006). In addition, a number of Canada's leading economists offered recommendations to one or both of the reviews; their submissions are also briefly summarized in this chapter.

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- 1 Please see chapter three (pages 47 ff.) for a discussion of the problems in the previous equalization program.
 - 2 These side agreements include special Offshore Accords to ensure that Nova Scotia and Newfoundland and Labrador do not experience reductions in equalization receipts owing to offshore resource revenues.
 - 3 For more information, see <<http://www.councilofthefederation.ca/>>.

Expert Panel on Equalization and Territorial Formula Financing

In 2005, the Expert Panel on Equalization and Territorial Formula Financing (hereafter referred to as the Panel) was commissioned by the federal government to review and assess the existing equalization program and provide recommendations for reform. The Panel, which released its report in June 2006, offered 18 major recommendations.

1 A clear set of principles should guide the future development of the program

The Panel recommended a set of clearly articulated principles to guide future developments of the program: consistency with Canada's Constitution; fairness; adequacy and responsiveness; policy neutrality and sound incentives; equity; simplicity; transparency; predictability and sustainability; affordability, and; accountability.⁴

2 A rules-based, formula-driven, approach should be used to determine the overall size of the program and individual provincial allocations

Prior to 2004, the equalization program depended on a formula to calculate both provincial entitlements and total program cost. The formula-based system, better known as the Representative Tax System (RTS), used average tax rates and tax bases in a well-defined formula to calculate provincial equaliza-

4 *Consistency with the Constitution* referred to harmony with the national purpose of equalization as expressed in Section 36 (2) of Canada's Constitution. *Fairness* referred to equal "rules of the game" for all provinces, implying equal and consistent treatment of all provinces. *Adequacy* referred to the provision of sufficient revenues to the provinces to meet the goals of equalization. *Responsiveness* was related to this principle in that it meant the ability of the program to respond to changes. *Policy neutrality* required respect for the autonomy of provinces in decision-making processes in areas of provincial responsibility that should be independent of the equalization program (*sound incentives*). *Equity* required that the financial position of equalization-receiving provinces are not stronger than non-receiving provinces. Two straight-forward principles were *simplicity* and *transparency*: the program should not be made excessively complex in the pursuit of accuracy and initiatives should be taken to improve general awareness and understanding of the program. The Panel advocated a more *predictable* system wherein financial shocks should be minimized. The Panel also stated that the program should be *sustainable* and *affordable* over time. Lastly, the Panel allocated *accountability* in the administration of the program to the federal government and the use of funds to the provincial governments. For further details, please see Expert Panel on Equalization and Territorial Formula Financing, 2006: 42–43.

tion payments. With the introduction of the New Framework in 2004, however, the formula-based approach was replaced by a fixed pool of funds that were allocated to provinces in an ad-hoc manner. The Panel recommended the use of a formula that embodied clear, transparent rules and accounted for the financial situation of the provinces.

3 Return to a 10-province standard

From 1982 to 2004, equalization payments were calculated based on the average revenue-raising capacity or fiscal capacity of five provinces (Ontario, Quebec, Manitoba, Saskatchewan, and British Columbia). The Panel recommended returning to a calculation of fiscal capacity based on all 10 provinces. Since adopting a 10-province standard might increase the total cost of the program, the Panel explicitly recommended a scaling mechanism to adjust equalization payments for receiving provinces on an equal per-capita basis. Essentially, this provision allows the federal government to scale back equalization payments should the program cost become excessively high.⁵ Furthermore, the Panel urged the federal government to clearly define parameters for determining affordability as part of a larger initiative to improve the transparency and governance of the program.⁶

4 Equalization should focus on fiscal capacity and not the expenditure needs of provinces

The Panel determined that it was impractical for the equalization program to include a measure (or measures) adjusting payments based on differing costs of delivering services. The Panel specifically noted the absence of a comparable measure of provincial services and costs. Measuring costs of delivery for comparable services is further complicated by the presence of a diverse menu of public services across provinces with different priorities. Given these difficulties, the Panel's recommendation was to retain the sole focus of equalization on differences in fiscal capacity.

5 Equalization should be the main program for equalizing provincial fiscal capacity

The Panel identified an equalization component in other federal transfer programs such as the Canada Health Transfer (CHT) and the Canada Social

5 However, Professor Francois Vaillancourt (2005) of the Université de Montréal pointed out that such issues will ultimately become a political decision.

6 The Panel suggested that indicators such as equalization entitlements as a share of Gross Domestic Product (GDP), federal program spending, and federal revenues would provide useful measures of assessing affordability.

Transfer (CST). The Panel argued that these equalization components in other programs added additional layers of complexity to the system of federal transfers and urged the two levels of government to make equalization the primary vehicle for equalizing provincial fiscal capacity.

6 Fiscal capacity should be assessed using the Representative Tax System (RTS)

The manner in which differences in fiscal capacity are calculated is extraordinarily complex. It is also one of the more difficult and politically charged aspects of reform since it determines the “winners” and “losers” of reform. After an in-depth analysis of alternative approaches, the Panel recommended the Representative Tax System (RTS) that uses 10-province average tax rates and tax bases to calculate equalization payments.

7 The Representative Tax System (RTS) should be simplified

Although the Panel supported the use of the RTS, it did acknowledge that the current system is overly complicated and difficult to understand. It recommended re-classifying the 33 tax bases currently used into 5 broad-based categories: personal income, business income, sales tax, property tax, and natural-resource revenues.

8 Residential property taxes should be assessed on market values of residential property

The Panel recommended a “stratified market value approach” to assess residential property tax revenues.⁷ This approach groups municipalities with similar average property values and assumes each group charges a similar average tax rate. The Panel advocated this approach on the grounds that it ties the market price of residential property together with the actual taxing practices of provinces.⁸

7 The panel noted that “[t]he stratified market value approach, using elasticities, is not perfect. But it is based on actual taxing practices, in keeping with the RTS, and it is clearly a marked improvement over the multi-concept base” (Expert Panel on Equalization and Territorial Formula Financing, 2006: 100). For further information, see the Expert Panel on Equalization and Territorial Formula Financing, 2006, Annex 5: 95–100.

8 Detailed databases for commercial-industrial and farm property-tax bases are not available. This prohibits a similar mechanism to be used for these property tax bases. The Panel recommended to continue using a multi-concept approach to measure provincial fiscal capacity on these property tax bases. The multi-concept approach is a fairly complex method that uses a mix of indicators (e.g. provincial GDP, disposable income, agricultural land values, and population changes) to assess the fiscal capacity arising from a property tax base.

9 User fees, with some exceptions, should be excluded from the calculations

User fees represent charges levied for the use of public-sector goods and services. The Panel concluded that these fees should be treated differently from other tax revenues since, unlike personal income tax or sales tax, user fees provide direct benefits to those who pay them. For this reason, the Panel maintained that such fees do not increase provincial fiscal capacity unless the revenue from such fees exceeds the costs of providing the public goods and services. Due to the extreme difficulty associated with user-fee calculations, the Panel recommended the exclusion of all user fees from equalization calculations with the exception of a few cases (the sale of alcohol, lottery tickets, and vehicle registrations) where such fees clearly generated profits that could be used to provide other public goods and services.

10 Natural resources should provide financial benefits to the provinces that own them

One of the most contentious aspects of the reforms being contemplated is the treatment of natural resource revenues. This is made all the more difficult by the fact that the proportion of natural-resource revenues collected as a percentage of total provincial revenues varies considerably from province to province. The Panel endorsed the principle that natural-resource revenues are a benefit to the provinces that collect them and must be included in equalization calculations. In response to provinces that voiced concerns over the equalization program's "claw-back" of resource revenues, the Panel argued that reductions in equalization payments were to be expected to some extent by provinces that realized substantial increases in resource revenues.⁹ The Panel did note, however, that equalization reforms must be cautious to avoid creating disincentives for the development of natural resources in each province.

11 Fifty percent of all resource revenues should be included in the equalization calculations

Like the previous issue, the proportion of natural-resource revenues included in equalization calculations is a critical and contentious aspect of the reforms. After an in-depth consideration of various proposals made on the appropriate rate of inclusion, the Panel advocated that 50% of all natural-resource revenues be included in the revised equalization calculations. The Panel's rationale for partial inclusion embodies the following criteria: (1) ownership

9 The well-documented phenomenon of "claw-backs" or the "tax-back problem" occurs when equalization payments to a resource-rich province are reduced, sometimes dollar-for-dollar, with an increase in resource revenues.

of natural resources is constitutionally conferred to provincial governments and hence, by right, they should be entitled to the revenues arising from such resources; (2) partial inclusion provides incentives for provinces to develop their natural resources; and (3) partial inclusion allows provinces to cover the costs of public infrastructure incurred in resource development.

12 Actual resource revenues should be used in calculations

After considering a number of alternative measures including an aggregate resource Gross Domestic Product (GDP) tax base and a new measure of resource rents,¹⁰ the Panel recommended the use of actual revenues in the calculation of entitlements. Although there is an incentive for provinces to manipulate their royalty rates (tax rates) to maximize entitlements, the Panel believed that such a possibility will be minimized by the incorporation of the 50% inclusion rate (Recommendation 11) and moving average mechanisms (Recommendation 16).

13 All resource revenues should be treated the same way

The Panel proposed that all resource revenues (oil, gas, forestry, minerals, hydroelectricity, and remittances from Crown corporations) be treated the same. Under the previous system, there were 14 separate categories of resource revenues and these were often treated differently.

14 A cap on entitlements should be in place such that an equalization-receiving province does not have a higher fiscal capacity after equalization compared to the fiscal capacity of the lowest non-receiving province

Of all the recommendations submitted by the Panel, this may be the most controversial. The Panel recommended a limit on payments to provinces to ensure that provinces that receive payments have a fiscal capacity that is not greater than the lowest contributing province.¹¹ That is, a province would experience a revision to its equalization payment if it was deemed to have a revenue-raising ability that exceeded the lowest province that contributed to equalization. The Panel also argued that the Offshore Accords for Nova Scotia and Newfoundland and Labrador should not compromise or adjust the cap requirement.

10 Resource rents capture the profits generated by resource extraction, development, and use.

11 Interestingly, the Panel suggested including the entirety (100%) of a province's resource revenues in determining the calculation of the cap. At the same time, the Panel offered reassurance that the cap would only limit, not eliminate, the benefits receiving provinces derive under Recommendation 11 (50% inclusion rate for resource revenues for equalization). For further details, see Expert Panel on Equalization and Territorial Formula Financing, 2006, Annex 10: 139.

15 A one-estimate, one-entitlement, one-payment approach to equalization should be adopted

In the past, equalization calculations were revised several times over a four-year period to reflect continually up-dated information. The Panel took the position that the quest for accuracy came at the expense of uncertainty in a province's entitlements and an inability to budget accurately. The Panel suggested that the equalization process be simplified by the use of a one-time estimate, one-payment, approach instead of continually adjusted entitlements based on up-dated information.

16 A three-year moving average, lagged two years, should be used to reduce the year-over-year fluctuations in entitlements.

To ensure provinces have a greater degree of certainty in their entitlements, the Panel suggested that equalization calculations be based on a three-year moving average lagged two-years. In other words, equalization payments would be based on a three-year average of fiscal capacity delayed two years due to information constraints. The Panel further recommended weighting the three years of data as follows: 50%, 25%, and 25%. For example, payments for the year 2007/08 would be based on an average of fiscal capacity data for 2005/06 (50%), 2004/05 (25%), and 2003/04 (25%).

17 The federal government should track and report measures of fiscal disparities to Parliament each year.

The Panel urged the federal government to publicly report key indicators of differences in provincial fiscal capacity (before and after equalization) on an annual basis.¹²

18 A rigorous process should be implemented to improve transparency, communication, and governance of the new program

The Panel proposed that any changes to the design or implementation of equalization be transparent and public. Such improvements could be achieved through: (1) annual reports from federal government on the program; (2) promoting public discussion and review of key issues or changes to the program; (3) retaining five-year reviews of the program; (4) improving the public's access to information on equalization; and (5) encouraging ongoing academic research on equalization.

12 Key indicators should include: per-capita fiscal capacities of provinces (before and after equalization); equalization payments as a proportion of GDP, federal revenues, and federal spending; provincial entitlements as a proportion of provincial revenues and expenditures.

Changes from the status quo

Table 4.1 illustrates the equalization outcomes resulting from the Panel's proposals for the year 2007/08. The total cost of the program is higher compared to status quo of the pre/2004 program (\$12.6 billion compared to \$11.7 billion), primarily due to the use of a 10-province rather than a 5-province standard.¹³ Under the Panel's approach, British Columbia would no longer become eligible for equalization and Newfoundland and Labrador will receive lower equalization payments compared to the status quo since the maximum cap applies to their entitlement, limiting their fiscal capacity after equalization to the level of Ontario's fiscal capacity.

13 Additionally, the calculations under the reforms reflect higher oil and gas prices.

Table 4.1: Comparison of outcomes (2007/08) from the recommendations of the Expert Panel on Equalization and a base-case scenario

	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC	Total
Recommendations of the Expert Panel on Equalization and Territorial Formula Financing											
<i>Total entitlements (\$ million)</i>											
	482	286	1,462	1,462	6,926	0	1,789	156	0	0	12,563
<i>Per capita entitlements (\$ per capita)</i>											
	933	2,079	1,560	1,945	917	0	1,528	157	0	0	
Base Case Scenario (a formula-driven approach similar to the pre-2004 system)											
<i>Total entitlements (\$ million)</i>											
	587	282	1,363	1,417	6,273	0	1,720	0	0	35	11,676
<i>Per capita entitlements (\$ per capita)</i>											
	1,136	2,047	1,454	1,885	830	0	1,468	0	0	8	
Changes											
<i>Total entitlements (\$ million)</i>											
	-105	4	99	45	653	0	69	156	0	-35	887
<i>Per-capita entitlements (\$ per capita)</i>											
	-203	31	105	60	86	0	59	157	0	-8	

Sources: Expert Panel on Equalization and Territorial Formula Financing, 2006: 10.

Council of the Federation

In 2005, the Council of the Federation¹⁴ commissioned an independent Advisory Panel to examine, assess, and provide recommendations regarding the country's potential fiscal imbalance. The Advisory Panel assessed both imbalances between the provinces (horizontal imbalance) as well as imbalances between the federal government and the provinces (vertical imbalance). The Advisory Panel's study was, therefore, much broader than that of the federal government's Expert Panel on Equalization and Territorial Formula Financing.

Horizontal fiscal imbalance

Some regions in Canada enjoy greater economic prosperity than others. This greater prosperity enables them to deliver a higher quantity and quality of public services. Horizontal fiscal imbalance refers to the disparity in the capacity of provinces to raise the revenues required to provide a given level of public services. Canada's equalization program attempts to rectify this imbalance between the provinces through a system of federal-provincial transfers.¹⁵

The Advisory Panel assessed five alternatives based on the criteria of fairness, transparency, and affordability.¹⁶ Each of the five options was based on a ten-province standard with 33 tax bases, of which 14 relate to natural resources. The five options differ only in the proportion of natural resource revenues used in the calculation (100%, 70%, 50%, 25%, and 0%).¹⁷

After analysing the various options, the Advisory Panel recommended that equalization be based on a 10-province standard with 100% inclusion of

14 The Council of the Federation is an organization of the provinces and is based in Ottawa, Ontario. For further details on its report, *Reconciling the Irreconcilable: Addressing Canada's Fiscal Imbalance*, see <http://www.councilofthefederation.ca/pdfs/Report_Fiscalim_Mar3106.pdf>.

15 While our focus here falls exclusively on the Advisory Panel's assessment of the equalization program, the analysis is equally applicable to the territories under the Territorial Formula Financing (TFF) program.

16 According to the Advisory Panel, an equalization formula is fair and transparent if it is comprehensive in its coverage of provinces and tax bases. Affordability, on the other hand, ensures that, while equalization meets the former criteria, the total cost of the program remains affordable to the federal government.

17 The Advisory Panel considered three options using partial inclusion of natural resource revenues (e.g. 70%) based on affordability and ensuring that jurisdictions were encouraged to develop their natural resource sectors. The total value of transfers under equalization falls as the inclusion rate for natural resource revenues declines: \$15.120 billion (at 100%); \$14.286 billion (at 70%); \$13.730 billion (at 50%); \$13.035 billion (at 25%); and \$12.341 billion (at 0%).

natural resource revenues. It argued that this approach best met the required criteria of fairness and transparency. This recommendation is in contrast to that of the federal government's Expert Panel, which preferred a partial inclusion rate for natural resource revenues (50%). The Advisory Panel also proposed a three-year moving average, lagged two years, for the calculation of equalization, which was identical to the Expert Panel's recommendation.

The Advisory Panel estimated that the total cost of the new program for 2005/06 under their full proposal (i.e. 10-province standard, 100% inclusion of resource revenues, with a three-year moving average lagged two-years) would be \$14.1 billion. The Advisory Panel acknowledged, however, that affordability might be a concern for the federal government. To address the affordability of the new program without compromising the criteria of fairness and transparency, the Advisory Panel proposed a scaling-down of the moving-average to a level that is affordable to the federal government. The federal government's Expert Panel was also in full agreement that a scaling mechanism should be used.

Table 4.2 illustrates the outcomes of the Advisory Panel's recommendations. In the absence of a scaling mechanism, the total cost of the program is \$14.067 billion. With a 1% scale-down of the 10-province average fiscal capacity, however, the standard decreases from \$6,207 per person to \$6,145 per person; total cost falls to \$13.071 billion.

Vertical fiscal imbalance

Vertical fiscal imbalance refers to a disparity between the revenue raising-abilities of the federal and provincial governments as compared to their spending requirements. The specific charge is that a vertical imbalance exists between the federal government, which is enjoying large and consistent surpluses, and the provinces, which are often struggling to maintain a balanced budget while providing a host of costly and Constitutionally-mandated services such as health care and education.¹⁸ Indeed, the Council of the Federation's Advisory Panel concluded that the federal government has experienced a growing budget surplus since 1997/98 while provincial governments are struggling to finance the growth in their spending. The Advisory Panel stated that this constituted a vertical fiscal imbalance.

18 For further discussion on vertical fiscal imbalance, please refer to the federal budget for 2006 (Canada, Department of Finance, 2006a), available online at <<http://www.fin.gc.ca/budget06/fp/fptoce.htm>> and the volumes in the Canada Strong and Free series by Mike Harris and Preston Manning (2005a, 2005b, 2006), available online at <<http://www.fraserinstitute.ca/strongandfree/index.asp>>.

Table 4.2: Outcomes from the recommendations of the Council of the Federation’s Advisory Panel—ten-province standard and 100% inclusion of resource revenues under a three-year moving average, lagged two years, on all revenues, subject to a 1% scaling of standard, 2005/06

	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC	Total
<i>TPS & 100% revenue coverage & 3-Year MA, Lagged 2 Years (\$M)</i>											
	963	261	1,429	1,390	6,487	0	1,710	345	0	1,483	14,067
<i>Measured fiscal capacity (\$ per capita)</i>											
	4,339	4,182	4,683	4,359	5,353	6,385	4,755	5,860	9,987	5,858	6,207
<i>Equalization payments (\$ per capita)</i>											
	1,869	2,025	1,524	1,848	854	0	1,452	347	0	349	
1% scale-down of standard											
<i>TPS & 100% revenue coverage & 3-Year MA, Lagged 2 Years (\$M)</i>											
	931	271	1,371	1,343	6,015	0	1,637	283	0	1,219	13,071
<i>Measured fiscal capacity (\$ per capita)</i>											
	4,339	4,182	4,683	4,359	5,353	6,385	4,755	5,860	9,987	5,858	6,145
<i>Equalization payments (\$ per capita)</i>											
	1,806	1,963	1,462	1,786	792	0	1,390	285	0	287	
<i>Change in Equalization payments (\$M)</i>											
	-32	10	-58	-47	-471	0	-73	-62	0	-264	-996
<i>Change in Equalization payments (\$ per capita)</i>											
	-62	-62	-62	-62	-62	0	-62	-62	0	-62	

Source: Council of the Federation, 2006: 87, Table 6.9. The table is a reproduction of Table 6.9 in the Advisory Panel’s report but there appears to be an error in the calculations for Prince Edward Island.

Perhaps more importantly, the Advisory Panel did not believe that an increase in provincial taxation was a solution since it would, in their opinion, exacerbate horizontal fiscal imbalance and undermine Canada’s overall tax competitiveness. Given these concerns, the Advisory Panel recommended the following measures.

1 Create a fully transparent Tax Point Adjustment (TPA) program

The Advisory Panel determined that the Associated Equalization (AE) program and the Supplementary Equalization (SE) program are equalization-type programs embedded in other transfer programs, namely, the Canada

Health Transfer (CHT) and the Canada Social Transfer (CST).¹⁹ The Advisory Panel argued, as had the federal government's Expert Panel, that the existence of multiple equalization programs outside the general program was damaging and ultimately undermined its transparency. Hence, the Advisory Panel recommended the consolidation of the additional programs into a separate, single fund called the Tax Point Adjustment (TPA) program.

2 Increase the Canada Health Transfer (CHT) and the Canada Social Transfer (CST)

The Advisory panel recommended increasing the CHT and CST from the current value of \$807 per person to \$960.²⁰ It further recommended that all of the incremental funding be allocated to the CST, which funds post-secondary education and social assistance services. The Advisory Panel suggested the increase in the CST in order to restore spending on post-secondary education and social assistance to their inflation-adjusted 1994 levels.²¹ Under this reform, CST would increase by \$4.6 billion to \$13.3 billion in current dollars.

3 Increase the growth rate of the Canada Social Transfer (CST)

In addition to increasing the value of the CST, the Advisory Panel also recommended increasing the growth rate of the CST from its current level of 3.3% per year to 4.5% per year.²² The Advisory Panel further recommended that this increase be established until 2013/14. It also supported the legislated 6% increase in the Canada Health Transfer (CHT) that is currently in place.

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- 19 According to the Advisory Panel, the additional equalization programs exist in order to equalize tax-point transfers (a component of CHT and CST) across provinces.
- 20 Robin Boadway, Sir Edward Peacock Professor of Economic Theory at Queen's University, made a similar proposal in his 2004 paper, in which he argued that the vertical fiscal imbalance should be addressed by increasing federal transfers to the provinces as opposed to lowering federal taxes and allowing provincial governments to increase their taxes to absorb the slack. He also suggested that increases in social transfers (for health, welfare, and postsecondary education) be tied to an index of provincial spending requirements. Further, he supported the allocation of such transfers to provinces on the basis of need. Dr. Harvey Lazar (2006), Director of the Institute of Intergovernmental Relations at Queen's University, also suggested that the imbalance be corrected through transfers and direct spending initiatives by the federal government.
- 21 Adjusting for inflation or rising price levels ensures that the \$960 per-capita transfer is equivalent to the 1994 transfer per person in terms of real goods and services.
- 22 The 4.5% is based on the Conference Board of Canada's projected annual spending increase in postsecondary education and social assistance. For further details, see the Conference Board's report (2002), available online at <<http://www.conferenceboard.ca/documents.asp?rnext=413>>.

Scholarly proposals for reform

Some of Canada's most influential scholars have weighed in on the debate on equalization either by submitting proposals to one or both of the panels reviewing the program or by publishing independent analyses of equalization. This section summarizes their recommendations.

Thomas Courchene

Professor Thomas Courchene of Queen's University is one of the country's acknowledged experts on equalization. Professor Courchene has published a number of major volumes on equalization as well as submitting to both panels (see Courchene, 2004a, 2004b, 2005a, 2005b, 2005c, 2005d; Courchene and Coplestone, 1980). His most recent work, *Resource Revenues and Equalization: Five-Province vs. National-Average Standards, Alternatives to the Representative Tax System, and Revenue-Sharing Pools* (2005c), which formed the basis for his submissions to the panels, is summarized below.

Professor Courchene made five key recommendations, three of which have gained consensus and were included in the recommendations of the Expert Panel. He recommended: (1) using a 10-province standard in the calculations for equalization; (2) including a portion of natural resource revenues; (3) aggregating all of the natural resource revenues into one revenue category; (4) capitalization; and (5) a two-tiered approach to equalization.

The return to a 10-province standard for equalization calculations has been thoroughly discussed previously in this chapter. However, the next two recommendations, namely the inclusion rate for natural resource revenues and the aggregating of all natural resources revenues into one revenue category, are worth reviewing.

Inclusion rate of natural-resource revenues

One of the more pressing issues in the current debate is whether or not to include natural-resource revenues in equalization and, if so, at what rate they should be included. Professor Courchene considered a number of alternatives (100%, 70%, 50%, 25%, 20%, and 0%) in reviewing the options for including resource revenues.²³ He concluded that a 25% inclusion rate for natural-resource revenues was the best alternative available. One of the

²³ The rates considered by Professor Courchene are not arbitrary: 70% represents the current "Generic Solution" inclusion rate; 50% represents the 1977 revision to resource revenue inclusion following the first energy price spike in 1973/74; 25% or 20% corresponds to estimated average federal income-tax rates; 0% represents equalization of non-resource revenues only.

reasons he came to this conclusion is that 25% is the estimated average federal income-tax rate (Courchene, 2005c: 27).

Professor Courchene also suggested the calculations use net resource revenues (resource revenues less development and revenue collection costs) instead of gross revenues as is currently the case. He recommended this provision on the grounds that it is unfair to reduce equalization to resource-rich provinces without accounting for the fact that some of the resource revenues go towards paying for development costs.

He also recommended simplifying the calculation by aggregating all of the natural resource revenue categories—currently 14—into one broad category. He concluded that the current system is overly complicated and costly as a separate tax base and tax rate must be assigned to each category. Additionally, he noted that arbitrary classifications of resource revenues can lead to favourable or unfavourable outcomes for certain provinces. For instance, potash revenues in Saskatchewan were sheltered to some extent under the “Generic Solution”²⁴ until potash was re-classified as part of a larger “minerals” category.

Capitalization

This recommendation and the next are unique to Professor Courchene and have not gained a consensus among the government review bodies. They are, nevertheless, critically important. According to Professor Courchene, “capitalization” refers to the degree to which provincial revenues are absorbed by the costs of providing public services. In the context of equalization, “full capitalization” occurs when provinces with higher (or lower) fiscal capacity have higher (or lower) wages, rents, and related costs, such that all provinces would be able to provide the same quality and level of public services. “Zero capitalization,” on the other hand, assumes that there is no difference in the costs of providing public goods across provinces. Canada’s Constitutional mandate for equalization assumes the latter case. Professor Courchene argued that both views are extreme and suggested a middle ground for a workable equalization program.

In addition, Professor Courchene argued that it is “real” public services, such as the number and quality of medical operations, the number of medical staff, and so on rather than just costs that should be considered. He suggested that, in calculating equalization payments, a “Capitalization Index” be used. The Index would be a weighted sum of expenditure categories of provincial governments (e.g. education, health, policing, social services, and administration).

24 The Generic Solution allows provinces with at least 70% of the national tax base to shelter up to 30% of its tax revenues from equalization.

Interestingly, this is an issue that the federal government's Expert Panel investigated and rejected due to its complexity. The Advisory Panel of the Council of the Federation, on the other hand, while receiving a broader mandate for review by the Council, did not even consider this aspect of equalization.

Two-tiered Approach to equalization

Perhaps the most widely known and innovative recommendation offered by Professor Courchene in *Resource Revenues and Equalization* was the creation of a two-tiered approach to equalization. He recommended two steps in calculating equalization payments: (1) normal equalization payments based on non-resource revenues; and (2) a voluntary pool of interprovincial resource revenues.²⁵

The first tier of equalization is relatively straightforward, while the second is both new and innovative. For the second tier of equalization, Professor Courchene considered two forms of the resource-sharing pool. The first was an integrated two-tiered system where a "have" province under the first tier (equalization of non-resource revenues) could not qualify for resource equalization under the second tier. The second alternative considered was an independent-tier system where any province that is resource-poor qualified for resource equalization.

Table 4.3 shows the estimates of the two-tiered approach under both the integrated and the independent systems for the year 2004/05. Under the integrated system, Ontario does not qualify for resource equalization since it is classified as a "have" province under the first tier (non-resource equalization). Under the independent-tier approach, however, Ontario qualifies for resource equalization equivalent to \$1,171.6 million.

James Feehan²⁶

Professor James Feehan of Memorial University focused on the issue of resource-revenue equalization in Harvey Lazar's volume on Canadian fiscal arrangements (Feehan, 2005; Lazar, 2005). This is a critical issue in the current debate since it sharply divides a number of provinces. Professor Feehan

25 Since the resource pool is a voluntary interprovincial transfer of resource revenues, Professor Courchene believed it may be politically impossible to implement without the intermediary of the federal government or a third party like the Council of the Federation. This pooling mechanism was also supported by Professor François Vaillancourt (2005) of the Université de Montréal.

26 For further details, see Feehan (2005).

Table 4.3: Resource revenue-sharing pool for 2004/05 (\$M)

NL	PE	NS	NB	QC	ON	MB	SK	AB	BC
20% resource-sharing pool;¹ "revenue-sharing," integrated-tier system (\$M)²									
-6.3	14.1	80.5	65.4	609.4	0.0	100.6	-74.9	-731.0	-57.7
20% resource-sharing pool;¹ "resource-sharing," independent-tier system (\$M)²									
-14.8	14.1	80.5	65.4	609.4	1,171.6	100.6	-175.7	-1,715.6	-135.4

Note 1: Although Professor Courchene generally recommended a 25% inclusion rate, he preferred a 20% inclusion rate for the above calculations (see Courchene, 2005c: 30).

Note 2: Values are negative for contributing provinces and positive for receiving provinces. The total does not sum to zero due to rounding.

Source: Courchene, 2005c: 44, table 4.

relied upon efficiency and equity as the determining criteria in formulating a policy on equalization for resource revenues.²⁷ Based on these criteria and recommendations made by other major federal government reports (Economic Council of Canada, 1982; Royal Commission on the Economic Union and Development Prospects for Canada ["Macdonald Royal Commission"], 1985; Boadway et al., 1983), Professor Feehan proposed that the treatment of natural-resource revenues be revised as follows: (1) return to a 10-province standard; (2) replace national average tax rates with potential rates; (3) set a partial inclusion of natural resource revenues at 25%; (4) make no distinction between renewable and non-renewable natural resources.

Professor Feehan's work laid an important foundation for the works of other academics and the federal Expert Panel in formulating recommendations on resource equalization. The Panel adopted most of his recommendations, three of which merit further review below.

Partial inclusion of resource revenues at 25%

A number of federal institutions and academics have recommended partial inclusion of resource revenues: the Economic Council of Canada (1982) proposed an inclusion rate of 15% to 20%; the Macdonald Royal Commission (1985) suggested 20% to 30%; and Professor Robin Boadway and colleagues (1983) recommended a rate of 25%. The rationale for partial inclusion spanned both economic and constitutional lines. Professor Feehan noted that the Eco-

27 Efficiency requires that factors of production (labour, capital, land, natural resources) are used most effectively. Equity requires the fair treatment of all provinces under equalization.

conomic Council of Canada best articulated the rationale for partial inclusion: the federal government should ensure its own policies are equitable across similarly situated people. Hence, in the case of resource revenues, only the proportion of those revenues equivalent to the federal income tax rate should be equalized since this would be similar to treating resource revenues as extra “income” for the residents of a province. A higher rate of inclusion for resource revenues would not be consistent with the constitutional provision of natural resource ownership by the provinces (*Constitution Act, 1982*: Section 92A).

Drawing upon these studies, Professor Feehan suggested an inclusion rate of 25% would be reasonable. He argued that partial inclusion is also desirable because it provides incentive for new resource developments: by sheltering a proportion of total resource revenues, provinces have greater incentives for realizing the potential of their natural resources. He also noted that an increase in program costs due to spikes in energy prices would not be severe under a 25% inclusion rate.

Professor Feehan also stressed that a long-term commitment to partial inclusion of resource revenues was critical in ensuring that provinces undertook concrete measures to develop their resource potentials fully. He argued that frequent and ad-hoc changes to the inclusion rate would dampen incentives to devise beneficial long-term policies for resource development.

No distinction between renewable and non-renewable natural resources

Professor Feehan argued that a distinction should not be drawn between these two categories of resources. A non-renewable resource like oil and gas could be converted into a source of ongoing revenue if the proceeds from the sale of these resources were invested in a heritage fund.²⁸ Conversely, renewable resources (forests, fish) can be depleted via over-exploitation. Given the difficulty in drawing a clear demarcation between the two, Professor Feehan recommended the symmetric treatment of the two types of resource revenues in the equalization formula.²⁹

28 A heritage fund is an investment of natural resource revenues on behalf of all the residents (current and future) by the provincial government, producing a future stream of investment earnings to be owned collectively and shared by the residents. For further details on the work of heritage funds, see the Alberta Heritage Saving Trust Fund website at <<http://www.finance.gov.ab.ca/business/ahstf/history.html>>.

29 In an important study, Professor John Hartwick (1977) of Queen’s University demonstrated theoretically that, under certain assumptions, non-renewable resources could generate an on-going flow of benefits if invested in physical assets (e.g. capital goods). This lends further support to the argument that there is no clear distinction between the two classifications of resource revenues.

Potential tax rates rather than national average tax rates

A recommendation by Professor Feehan that did not gain a consensus in the Expert Panel's report but is nevertheless interesting is the use of potential tax rates instead of actual tax rates for resource-revenue equalization.³⁰ As mentioned earlier, provincial governments have a tendency to under-collect resource revenues under the present system. To overcome this inefficiency, Professor Feehan proposed the use of tax rates that reflect the true income potential of these resources or their "economic rent." He believed that the environmental and efficiency gains of this proposal would be substantial since resource royalties (tax rates) would come close to reflecting their true values instead of being under-priced and over-exploited.

Although Professor Feehan acknowledged some practical difficulties in determining true royalty rates, he noted that some Canadian economists have developed promising methodologies.³¹ Further, he pointed out that the federal government had introduced some changes during the period from 1999/2000 to 2003/2004 that represented a positive step in this direction.³² Despite the complexity of using potential tax rates, Professor Feehan believed that reasonable rules of thumb based on sound economic analysis would provide a starting point for such endeavours.

Paul Boothe

Professor Paul Boothe of the University of Alberta has published a number of studies calling for fundamental reforms to the existing system of federal-provincial transfers (e.g. Boothe, 1998, 2002a, 2002b). In *Simply Sharing: An Interprovincial Equalization Scheme for Canada* (Boothe and Hermanutz, 1999), Professor Boothe and Derek Hermanutz pointed out serious flaws in the equalization program, the Canada Health and Social Transfer (CHST) program,³³ and the regional component of the Employment Insurance (EI) program. To address these flaws, they proposed two critical recommendations that would result in a fundamental overhaul of the current transfer scheme: (1) a net interprovincial transfer system; (2) a macro formula to determine the value of transfers.

30 Professor André Plourde (2005) from the University of Alberta, amongst others, was not in favour of this technique due its immense complexity.

31 The work of Zuker and Jenkins (1984) is amongst the most noteworthy in this area.

32 Improvements in oil and forestry revenue calculations ensured that they were more closely in line with economic rents (profits) from these resources. Additionally, mineral tax bases were defined in terms of the mining companies' profits instead of sales or volume figures.

33 The CHST was a predecessor of the current Canada Health Transfer (CST) and Canada Social Transfer (CST) programs.

The recommendations were designed to be comprehensive in their coverage, looking beyond the equalization program to include the CHST and the regional component of EI. Although the reports of the Expert Panel and the Advisory Panel acknowledged the integrated nature of federal transfers, they favoured a separate equalization program to address provincial differences in revenue-raising (fiscal) capacity.

Net interprovincial transfer system

Professor Boothe and Mr Hermanutz felt that the existing transfer scheme was too large and suggested a smaller, streamlined system. Under the new scheme, the federal government would no longer transfer funds to the provinces. Instead, it would eliminate the current federal transfer programs (equalization, CHST, and the regional component of EI) by transferring Personal Income Tax points (revenues) equivalent to the total cost of the federal transfer programs to the provincial governments in proportion to each province's contribution to federal income-tax revenue. A portion of these revenues would be allocated to an interprovincial transfer fund. Initial contributions to, and withdrawals from, the fund would be designed such that they would have no effect on provincial budget positions. Future transfers under the interprovincial transfer system would be calculated using a simple macro formula (discussed below) and would be made directly among provinces with the federal government playing the role of a guarantor and overseer of the system.

Macro formula to determine the value of transfers

Instead of a complex equalization formula that used 33 tax bases, Professor Boothe and Mr Hermanutz suggested a simpler formula based on a key macro (economy-wide) indicator to determine future interprovincial transfers. After a detailed assessment of alternative measures, Boothe and Hermanutz chose Adjusted Personal Income (API) as the key indicator in the macro formula.³⁴ Boothe and Hermanutz also suggested using a multi-year average (e.g. five years) of the macro indicator in order to increase predictability of the transfer payments for the provinces.

Under the combined net interprovincial transfer system and the macro formula, the estimated net transfers were higher for Newfoundland, Prince Edward Island, British Columbia, Alberta, Quebec, and Saskatchewan compared with the actual net transfers for 1996/97. Although Ontario's net

34 Adjusted Personal Income (API) is calculated as personal income less federal direct tax withdrawals and federal GST collected. Federal direct tax withdrawals include federal income taxes, employer/employee contributions to EI and Canada and Quebec Pension Plan premiums.

transfers remained largely unchanged, Nova Scotia, New Brunswick, and Manitoba had lower predicted net transfers than actual net transfers.

Finally, Professor Boothe and Mr Hermanutz stressed that effective governance of the redesigned program was critical for its success in the long run.

Dan Usher

Professor Dan Usher, along with Thomas Courchene, his colleague at Queen's University, are widely acknowledged as two of the country's leading experts on equalization.³⁵ Professor Usher's suggested reforms to equalization are based on the "Macro Formula," a key revision to the equalization formula that has been widely documented in a number of his publications. Although the two government reports preferred the Representative Tax System (RTS), Usher's Macro Formula provides an important alternative.

The RTS approach, which was adopted at the inception of the equalization program, uses tax rates and tax bases in the calculation of equalization payments. Professor Usher's alternative, the Macro Formula, is based on income per person (Usher 1995, 2005). The Macro Formula uses national and provincial average income per person and a national tax rate³⁶ instead of average tax rates and tax bases for 33 revenue categories employed under the existing equalization system.³⁷

Professor Usher recommended the Macro Formula on the grounds that it would overcome some of the principal difficulties associated with the Representative Tax System (RTS): (1) equalization from poor to rich; (2) treatment of collective income; (3) distortion of incentives for provincial governments; and (4) complexity (Usher, 2001).

1 Equalization from poor to rich

Professor Usher criticized the RTS because equalization payments may result in a transfer from a province where people are poor on average to one where people are rich on average because transfers are not based on the average income per person in a province. For example, a rich province with a few

35 For Professor Usher's key work on equalization and the "Macro Formula," see Usher 1995, 2001, 2005, 2006.

36 The national tax rate is the ratio of the sum of tax revenues across all provinces to the national income of Canada.

37 In a recent unpublished paper (2006), Professor Usher further proposed that equalization payments to poor provinces based on the Macro Formula should be directly funded by rich provinces, requiring no additional revenue from the federal government. This proposal is similar in spirit to the one made by Dr Alex MacNevin (2004).

below-average tax bases (e.g. limited resource revenues) might be incorrectly classified as a “have-not” province according to the existing equalization formula and receive equalization. In such a situation, the effect of equalization might unintentionally transfer funds from poor provinces to rich provinces. This is extremely undesirable from the perspective of the program’s initial objective, which aims at transferring income from people in rich provinces to people in poor provinces. The Macro Formula is immune to such perverse outcomes since equalization payments are directly related to the economic prosperity of provinces, where prosperity is measured as income per capita in the broadest sense of the word.

2 Treatment of collective income

Revenues that directly accrue to provincial governments represent income that is collectively owned by the residents of the province; a good example is revenue from resources. Professor Usher argued that under the RTS, collective income has two potential effects on equalization payments: they either reduce equalization dollar-for-dollar or, if manipulated by provincial governments, may reduce equalization less than dollar-for-dollar. However, he maintained that the Macro Formula would avoid this distinction since all sources of income (including collective income) are included under national and provincial income per person, leaving little or no room for manipulation.

3 Distortion of incentives for provincial governments

One of Professor Usher’s chief criticisms of the RTS is that it creates incentives for provincial governments to manipulate tax rates to maximize equalization entitlements. Provinces have an incentive to levy high taxes on small (below average) tax bases and low taxes on high (above average) tax bases. Each province attempts to improve its own position, disregarding its effects on other provinces. The Macro Formula allows very limited room for such manoeuvres since, unlike tax rates and tax bases, national and provincial average income per person would be extremely difficult for provinces to manipulate.

4 Complexity

With 33 tax bases used in the calculations, the RTS creates room for conflict and negotiation between provinces and the federal government. There is no single formula or tax rate that can be agreed upon by the different parties. Professor Usher believed that the simpler and more straightforward approach of the Macro Formula and its reliance on data from national income accounts that are available to all parties would provide less scope for conflict.

Personal income tax and “comparable levels of taxation”

In addition to the above arguments, Professor Usher defended the Macro Formula’s reliance on income per person on the grounds that personal income tax is the ultimate measure of a person’s tax “burden” (2005). In his view, “taxes paid as a proportion of one’s income” embodied the true meaning of the phrase “comparable levels of taxation” in the 1982 Constitutional mandate. He dismissed all other taxes as being taxes on income, where “income” is defined in the broadest sense of the word (Usher, 2005: 18).

Mechanisms for greater flexibility

As further evidence of the Macro Formula’s practicality, Usher argued that it could be adjusted to incorporate mechanisms that would introduce greater flexibility (2001).

- 1 *Needs* The macro formula might be adjusted to account for variations in the “needs” of different provinces (e.g. higher health care costs in British Columbia). Professor Usher did, however, argue that such a provision was controversial since differences in provincial needs are extremely hard to measure.
- 2 *Transfers* All incomes inclusive of federal transfers (e.g. unemployment insurance) should be ideally considered in equalization calculations under the macro formula.
- 3 *Depreciation* As a corporation’s income is assessed for taxation after depreciation³⁸ provisions are deducted, so too should provincial income per person be considered for equalization after accounting for depreciation.
- 4 *Price levels* If province *A* has double the income per person of province *B* but its average price level is four times that of province *B*, its standard of living is lower than that of province *B*. Professor Usher suggested that the Macro Formula could be adjusted to reflect such price differences between provinces.
- 5 *Out-of-province tax bases and collective income* Corporate income-tax revenues and resource revenues can sometimes be collected from residents who live outside a certain province. For instance, if an Albertan owns shares in a firm located in British Columbia, a tax on the firm’s profits is in effect partly

38 Depreciation is defined as the loss in the value of assets (e.g. machinery, equipment, etc.) due to wear and tear and to technological progress that makes assets obsolete.

levied on the income accruing to the shareholder in Alberta. Additionally, resource revenues that accrue directly to provincial governments are owned collectively by the residents in a province. To account for these special cases, Professor Usher recommended the inclusion of all income sources in the Macro-Formula calculations.

Jack Mintz and Finn Poschmann

Jack Mintz and Finn Poschmann of the C.D. Howe Institute offered fairly stern criticisms of Canada's equalization program based on their assessment that the existing equalization formula did not adequately measure the revenue-raising capacity (fiscal capacity) of provinces (Mintz and Poschmann, 2004). They argued that a reformulation of fiscal capacity was required to address the current shortcomings. Specifically, they argued that the current equalization formula led to the following inefficiencies: (1) it created disincentives for provinces to develop their natural resources since any additional revenue from these sources leads to a reduction in equalization payments; (2) it undermined incentives for economic development since provinces that set lower taxes to encourage investment will be penalized through a reduction in their entitlements; and (3) there is little motivation to reduce debt since provincial government borrowings to finance spending does not affect equalization receipts.

The last point has important implications since an increase in government borrowing today must be financed by increasing future taxes to repay debt and interest payments, a burden that will inevitably fall on future tax payers. Mintz and Poschmann presented data showing that the per-capita debt among equalization-receiving provinces has been, on average, almost double the level of the remaining provinces for the previous 15 years (2004: 3): provincial debt as a percentage of GDP was approximately 36%, on average, among the recipient provinces but 14% among the non-recipient provinces.

Cash-flow equalization

Until 2004, a province's fiscal capacity was measured by comparing tax bases per person for each province against a "standard" base for each of 33 tax categories, an approach better known as the Representative Tax System (RTS). Mintz and Poschmann argued that a better measure of fiscal capacity was required and they recommended the use of a "cash-flow equalization" as an alternative. Although this proposal did not gain a consensus in the government reports, its rationale merits further examination.

Mintz and Poschmann defined cash-flow as: per-capita, year-over-year change in financial liabilities³⁹ as at March 31 + interest income received – (Year-over-year change in financial assets⁴⁰ + Interest paid in the year). They used a five-province, per-capita, cash flow as the “standard” against which to compare the provincial per-capita cash flows. They recommended that equalization payments be calculated as the difference between the five-province, per-capita, cash flow and each province’s per-capita cash flow multiplied by a province’s population.

Mintz and Poschmann also noted that this approach would exclude the following types of cash inflows from equalization calculations: (1) the revenue used to fund investments in financial assets; (2) the revenue used to repay government debt; and (3) additional provincial borrowing or proceeds from the sale of financial assets (including natural resource revenues) that are used for new investments in assets or to repay government debt.

Mintz and Poschmann stated that these reforms would encourage provincial governments to engage in new investments in assets, repay their debts, and spend public funds wisely by not increasing spending excessively. Table 4.4 shows the effect of switching to a cash-flow equalization system as recommended by Mintz and Poschmann. As indicated, the cash-flow system would alter the magnitude of entitlements to some extent: British Columbia no longer qualifies for equalization whereas Saskatchewan and New Brunswick gain as much as 85% and 44% from the switch to the cash-flow system.

One important issue raised by the authors is the transition. If the new system did not distinguish old government debt from new debt, provincial governments that repaid their old debt would benefit from increased entitlements. On the contrary, provincial governments that benefit from old investment incomes or wish to sell some of their assets acquired prior to the transition would face the penalty of lower entitlements. One solution offered by Mintz and Poschmann would be to distinguish “old” debt, interest payments, financial assets, and investment income from “new” items and completely exclude them from the equalization calculations. However, they believed that the simplest solution involving the least administrative effort would be not to make such a distinction.

39 The Financial Management System (FMS), based on data generated by Statistics Canada, groups several items under financial liabilities including payables, advances, treasury bills, savings bonds, bonds and debentures, other securities, deposits, bank overdrafts, and liabilities to pension plans. See Statistics Canada, 2006.

40 The Financial Management System (FMS) classifies financial assets as cash on hand and deposits, receivables, advances, securities and other financial assets. See Consolidated Federal, Provincial, Territorial and Local General Government Balance Sheet Canada 2006.

Table 4.4: Equalization entitlements for 2002/03 under cash-flow equalization method

	NL	PE	NS	NB	QC	ON	MB	SK	AB	BC	Total
<i>Actual equalization payments (\$M)</i>											
	875	235	1,122	1,143	4,004	0	1,303	106	0	71	8,859
<i>Equalization payments under casflow method (\$M)</i>											
	703	199	1,072	1,649	4,519	0	1,647	196	0	0	9,985
<i>Change in Equalization payments (\$M)</i>											
	-172	-36	-50	506	515	0	344	90	0	-71	1,126
<i>% Change in Equalization payments</i>											
	-20%	-15%	-4%	44%	13%	n/a	26%	85%	n/a	-100%	13%

Sources: Canada, Department of Finance, 2006b; Mintz and Poschmann, 2004: 7.

Beverly Dahlby

Professor Beverly Dahlby of the University of Alberta provided a comprehensive evaluation and a number of recommendations on Canada's equalization system. In his submission to the Expert Panel, *Review of the Canadian Equalization and Territorial Funding System* (2005), Professor Dahlby made the following key recommendations: (1) the use of an alternative measure of fiscal capacity, the Efficient Tax System; (2) the special treatment of property taxes; (3) the partial inclusion of natural resource revenues and the exclusion of user fees; (4) the use of three- to five-year averages of revenues per person to improve stability and predictability; and (5) the creation of an advisory commission for research into equalization. With the exception of the first, all recommendations were favourably viewed and largely adopted by the federal government's Expert Panel in its report. The Expert Panel did, however, make some slight departures from Professor Dahlby's initial recommendations and these are reviewed below.

Treatment of Property Tax Revenues

Professor Dahlby argued that revenue from property taxes are a special case because the tax base for property (e.g. the value of residential housing) is relatively inelastic with respect to the tax rate: an increase in the residential property tax rate does little to change the value of residential housing (the tax base). Since the Representative Tax System (RTS) that relies upon tax rates and tax bases in equalization calculations does not account for tax-rate

sensitivities, Dahlby proposed a modification in the calculation of equalization payments arising from property tax revenues. Although these specific modifications were not included in their report, the Expert Panel gave special consideration to the treatment of property-tax revenues.

Treatment of user fees and the partial inclusion of resource revenues

Professor Dahlby recommended the complete exclusion of user fees from equalization, arguing that user fees count towards provincial revenue only by the amount it exceeds the cost of providing an extra unit of service. Since it is difficult to estimate such amounts for all provinces, Professor Dahlby suggested that it is best to exclude all such fees. However, the Expert Panel favoured the inclusion of a few items that generate profits.

One of the reasons that Professor Dahlby favoured the partial inclusion of resource revenues is that the equalization system is funded by the federal government out of its general tax revenues. Given this constraint, he argued that it does not make sense to impose high federal personal income taxes across the country in order to make substantial equalization payments to the Atlantic provinces and Quebec arising from resource revenues in western Canada. The burden of this policy would be largely borne by Ontario residents, with deleterious effects on equity and economic efficiency.⁴¹ The federal government's Expert Panel acknowledged this concern in their report although they did not explicitly state this as one of their motives for recommending partial inclusion of resource revenues.

Advisory commission

Professor Dahlby proposed the creation of an independent advisory commission that would provide ongoing research into equalization. He believed that such a mechanism would bring beneficial long-term improvements and changes to the system. The Expert Panel preferred a federal initiative to achieve the same objective.

The Efficient Tax System (ETS)

A unique and critical recommendation made by Professor Dahlby involved a revised understanding of fiscal capacity called the Efficient Tax System. Due to its complexity, however, the two government panels unanimously agreed upon the Representative Tax System (RTS) as the favoured basis for measuring fiscal capacity.

41 This view was expressed by Professor Dahlby in his review of Alex MacNevin's (2004) work on equalization.

Professor Dahlby and his colleague, Professor Sam Wilson, also from the University of Alberta, were among the first to point out that a key justification of the equalization system was to reduce the difference in the marginal cost of public funds (MCFs) across provinces (Dahlby and Wilson, 1994). In theory, the government's effort to raise a dollar in taxes will "cost" society more than a dollar because firms and households will change their behaviour in ways that affect the total output of an economy. For example, firms and households will channel their activities (production, investment, and consumption) away from more productive but taxed activities to less productive but untaxed activities. This diversion causes resources to be allocated in a less efficient manner and results in a decline in the size of the "economic pie."

As a second example consider how economic participants plan their activities with respect to taxes: households and firms will attempt to pay less tax through both tax avoidance and tax evasion. Both activities represent a waste of resources. The extent to which this evasion takes place depends on the sensitivity to the tax rate of the underlying tax base. In other words, it depends on the degree to which households and firms change their behaviour to avoid paying tax.

The marginal cost of public funds (MCF) is a theoretical measure of the above costs—the shrinkage of the "economic pie" and tax evasion—and is directly related to the sensitivity to the tax rate of the underlying tax base. Professors Dahlby and Wilson proposed an alternative measure of fiscal capacity called the Efficient Tax System (ETS) that is also directly related to the tax-rate sensitivity of the underlying tax base. Unlike the Representative Tax System (RTS), the ETS explicitly recognizes sensitivities to tax rates.⁴² Essentially, the objective of equalization under the new definition of fiscal capacity is to minimize the total cost of collecting a given amount of tax revenue.

Alex MacNevin

Dr. Alex MacNevin, an independent consulting economist from Nova Scotia, provided a critical examination of equalization reform in *The Canadian Federal-Provincial Equalization Regime: An Assessment* (2004), published by the Canadian Tax Foundation. Based on his comprehensive assessment, Dr. MacNevin concluded that the Canadian equalization program had fallen short of its constitutional mandate and required fundamental reforms. In particular, he argued that the existing Representative Tax System (RTS) that used average tax rates and tax bases had the following key weaknesses: (1) it

42 One difficulty with this approach is that ETS requires the estimation of tax-rate sensitivities that are currently unavailable and require complex empirical work.

was not an adequate measure of the revenue-raising (fiscal) capacity of provinces; (2) it did not address variations in the expenditure needs of provinces; and (3) it created perverse incentives on provincial governments to manipulate tax rates and bases to maximize equalization grants.

In order to address these and other identified weaknesses, Dr MacNevin proposed the following package of reforms: (1) adoption of an adjusted macro approach to measuring fiscal capacity that explicitly accounts for tax exporting; (2) accounting for the expenditure needs of provinces; (3) adoption of a net-funded or an integrated approach to equalization; (4) improving program administration, awareness, and transparency. The Expert Panel did not endorse these proposals but three especially are worth a closer look.

Adjusted macro approach

Dr MacNevin argued that, in principle, fiscal capacity should be based on the ability of provinces to raise revenues instead of the actual revenues raised by provinces. In order to capture a province's revenue-raising ability, he recommended the adoption of a Total Taxable Resources (TTR) approach, which is based on a comprehensive measure of income accruing to the residents of a province. Additionally, he stressed the importance of including measures of tax exporting in the calculation of provincial fiscal capacity.⁴³ Tax exporting represents the proportion of a province's potential revenue collected that can be attributed to non-residents. Dr MacNevin argued that the inclusion of tax exporting was essential to obtain a complete measure of fiscal capacity. He recognized, however, that, although accounting for tax exporting in equalization is theoretically attractive, there are extreme practical difficulties associated with it.

Accounting for the provinces' expenditure needs

Dr MacNevin argued that the incorporation of expenditure needs in the equalization calculations was necessary in order to ensure that all provinces had sufficient revenues to finance their expenditures.⁴⁴ He suggested an index of expenditure needs that would incorporate a broad range of factors including the composition of the population, environmental and technical factors, and the costs of inputs. However, Dr MacNevin considered that such a fundamental reform was impracticable in the short run and suggested

43 This is similar to Professor Usher's (2001) recommendation on out-of-province tax bases.

44 A recent empirical case for expenditure needs was also made by Crowley and O'Keefe (2006a). Professor Courchene (2005c) also addressed the similar, albeit narrower, issue of accounting for the costs of providing public services.

incremental changes at the outset. For instance, he proposed the use of a less formal assessment of needs made by independent panels.

Net-funded or integrated approach

Dr MacNevin stated that, ideally, equalization should be a net-funded scheme whereby the “have” provinces contribute revenues to the “have not” provinces. However, in the likely event that a net-funded scheme proved to be politically infeasible, Dr MacNevin suggested an alternative arrangement that involved the integration of the equalization program with the Canada Health and Social Transfer (CHST) program. The CHST (which later evolved into two separate programs, the Canada Health Transfer and the Canada Social Transfer) provided federal transfers for financing health, post-secondary education, and social programs in the provinces. The CHST transfers are generally advocated on the grounds that they address vertical fiscal imbalance, a situation where there is a difference in the revenue-raising abilities of the federal and provincial governments.⁴⁵ On the other hand, the equalization program aims at rectifying horizontal fiscal imbalance, the difference in the revenue-raising abilities of provinces. Dr MacNevin argued that an integration of equalization and CHST could be arranged such that both horizontal and vertical fiscal imbalances can be addressed collectively under the integrated program by the federal government.

Atlantic Institute for Market Studies (AIMS)

The Atlantic Institute for Market Studies (AIMS) has undertaken a great deal of work on equalization.⁴⁶ This substantial body of research led to a formal submission to the federal government’s Expert Panel (Winchester, 2005) as well as the AIMS Special Equalization Series. Some of the key recommendations proposed by AIMS authors are as follows: (1) return to a 10-province standard; (2) exclude non-renewable natural resources; (3) cap equalization payments based on per-capita spending; (4) adopt a federal-provincial debt swap; (5) use a system of provincially differentiated taxes; and (6) use a needs-based approach to equalization.

45 Typically, a vertical fiscal imbalance entails excess funds (revenues) for the federal government but a shortage of funds for the provincial governments relative to their spending requirements.

46 For further information on the work of the Atlantic Institute for Market Studies (AIMS), please see their website at <<http://www.aims.ca>>. Studies of the equalization program include Boessenkool, 2001, 2002a, 2002b; Buchanan, 2002; Crowley, 2002, 2005; Crowley and McIver, 2004; Crowley and O’Keefe, 2006a, 2006b, 2006c; Dahlby, 2002; Martin, 2001; McMahon, 1996, 2000; Neill, 2006; Winchester, 2005.

Excluded non-renewable natural resources

This proposal was the topic of *The 100 Percent Solution* (Crowley and O’Keefe, 2006c), a recent AIMS commentary on equalization written by the President of AIMS, Brian Lee Crowley, and policy analyst, Bobby O’Keefe. Crowley and O’Keefe argued that non-renewable natural resource revenues have two distinct characteristics: (1) they are generated from finite resources; and (2) they are unstable due to large price fluctuations. They stressed that the uniqueness of non-renewable resources had not been given serious consideration in efforts to realize a workable solution for resource revenue equalization.

Crowley and O’Keefe maintained that recognizing the nature of non-renewable resource revenues required special treatment of such revenues in equalization. Non-renewable resource revenues should not, in their view, be considered as revenues contributing towards “fiscal capacity.” Instead, they proposed that such revenues be treated as “assets” and expended on efforts to (1) reduce accumulated provincial debt and (2) create a heritage or trust fund, an investment fund that yields investment earnings to be collectively owned and shared by provincial residents.

They argued that using non-renewable resource revenues for debt reduction would create substantial future savings that could in turn be used to improve public services. Their estimates indicated significant long-term benefits accruing from debt reduction to British Columbia, Newfoundland and Labrador, Nova Scotia, and Saskatchewan. On the other hand, if the resource revenues were invested in a heritage fund, Crowley and O’Keefe proposed that only the investment income generated from the fund should be included in the equalization calculations.⁴⁷

The exclusion of non-renewable resource revenues was also one of the key proposals in the presentation made by Bruce Winchester, AIMS Director of Research Services to the federal government’s Expert Panel in 2005.⁴⁸ Winchester’s arguments were broadly similar to those made by Crowley and O’Keefe. He also noted that the exclusion of non-renewable resource revenues from equalization calculations would remove the disincentive effects faced by resource-rich provinces to develop their natural resources. Currently, provinces that experience increases in resource revenues face reductions in equalization payments (the tax-back problem). The Expert Panel did not, however, endorse this suggestion but instead proposed a 50% inclusion rate of the total resource revenues (renewable and non-renewable) for each province.

47 See Plourde, 2005 for a similar proposal on the treatment of non-renewable resources.

48 Winchester, 2005. Winchester’s recommendation was largely attributed to Boessenkool’s work (2001) on resource revenues.

In sum, these AIMS authors proposed the complete exclusion of non-renewable natural resources from the calculations of fiscal capacity in equalization, conditional on the use of these funds to retire provincial government debt or acquire assets (i.e. investment in a heritage or trust fund).

Cap equalization payments based on per-capita spending

To ensure that equalization entitlements do not encourage recipient provinces to increase spending that will eventually be financed out of the tax dollars of other provinces, Winchester (2005) recommended placing a cap on equalization payments based on either a national spending average or a proportion of total spending. The national average would be the average of provincial spending in key areas like health, education, social services, justice and protection, transportation and communications.⁴⁹

Adopt a federal-provincial “debt swap”

Winchester (2005) observed that equalization-receiving provinces had accumulated large amounts of debt and that, for many provinces, equalization merely helps to cover interest payments on debt and does not improve the revenue-raising capacity of provinces (fiscal capacity). To reduce dependence on equalization to sustain indebtedness, Winchester proposed the allocation of a proportion of total equalization entitlements towards the repayment of provincial government debts. He also suggested the use of safeguards that would prevent provincial governments from taking advantage of a debt-reduction provision. For instance, safeguards can require provincial governments to balance their books before they become eligible for the “debt swap”⁵⁰ or tie debt swaps to a proportion of equalization payments. Eventually, the author argued, this measure would bring substantial savings in the interest on debt that would improve provincial fiscal capacity in the long run.

Use a system of provincially differentiated taxes

In a recent AIMS study on equalization, Robin Neill, AIMS Chairman of the Board of Research Advisors and Adjunct Professor of Economics at the

49 Interestingly, the federal government’s Expert Panel adopted the principle of a cap on equalization payments although the criterion for defining the cap was fairness: a province receiving equalization should not have a fiscal capacity after equalization that is higher than the lowest fiscal capacity among non-receiving provinces.

50 Although in conventional usage, a “debt-swap” is an agreement between two parties to exchange their debt to obtain monetary gains, Winchester re-defines the term to suit his proposal.

University of Prince Edward Island and Carleton University, proposed a theoretical solution to achieve the goals of equalization more efficiently (Neill, 2006). He proposed a system of provincially differentiated taxes instead of the existing system of equalization transfers. Essentially, the proposed system entailed a reduction of federal taxes with a corresponding increase in provincial taxes in each province to take up the slack. Hence, instead of the federal government's providing equalization transfers, each province would finance a roughly equal level of public services with the increase in provincial taxation. Professor Neill argued that this system had the distinct benefit of eliminating the problems associated with a fiscal imbalance since the decision to tax and spend would be made by the same province.⁵¹

Use a needs-based approach to equalization

In *Why Some Provinces Are More Equal than Others*, another recent AIMS Commentary on equalization, Brian Lee Crowley and Bobby O'Keefe identified a serious inequity issue arising from an equalization system that did not account for differences in the costs of providing public services across provinces (Crowley and O'Keefe, 2006a). They adjusted the federal Expert Panel's estimates of the revenue-raising (fiscal) capacities of each province after equalization for 2007/08 with a "cost adjustment factor." They found that the adjusted fiscal capacities varied considerably—the exact opposite of what was intended by an equalization program. More disturbingly, they found that many provinces receiving equalization ended up with a higher fiscal capacity compared to Ontario in the revised calculations. Indeed, equalization "over-equalized" the have-not provinces.⁵²

From these results, Crowley and O'Keefe argued that their estimates favoured a needs-based approach to equalization that would explicitly recognize, and account for, the differences in the costs of delivering public

51 Fiscal imbalance, in this context, differs from the same term used in the Council of the Federation's report (2006). As used by Professor Neill, a fiscal imbalance occurs when one government (federal) makes decisions to tax while another (provincial) makes decisions on spending the revenues generated from the tax. Since taxing and spending decisions are not made by the same authority, provincial governments of equalization-receiving provinces may not have incentives to use the equalization transfers in the most efficient manner. Note that this applies in the context of an equalization system funded by federal taxation.

52 In a separate study, Crowley and O'Keefe (2006b) also found that, in provinces receiving equalization, levels of public-service employment, public-sector wages, and levels of debt were higher than average. They suggested that this might provide further evidence of the program's failure to achieve its constitutionally mandated objectives.

services in each province. They maintained that this approach would ensure that each province received what it requires to produce a reasonable level of public services.

Conclusion

The increasing awareness of the problems associated with equalization has spurred leading academics and government-commissioned panels to propose a number of reforms. Some of these reforms are gaining consensus. For example, it is now widely recognized and acknowledged that a rules-based, formula-driven, approach based on clearly defined principles should be adopted for determining equalization. There is also substantial consensus on returning to a 10-province national standard as opposed to the current five-province standard. Predictability and affordability of payments have also been recognized as important and there is increasing agreement that multi-year averages should be used to reduce year-over-year uncertainty in equalization receipts. Finally, a majority of commenters have proposed that equalization should become the main program for equalizing provincial fiscal capacity and such efforts should not, in principle, spill-over into other federal programs.

Several high-profile recommendations have not, however, gained consensus amongst either academics or government review panels. One such series of recommendations involves an alternative assessment of provincial fiscal capacity, specifically the Macro Formula. Another radical approach involves the use of cash-flow equalization. There has also been considerable contention over the importance of accounting for the expenditure needs of the provinces and the costs of providing public services in the equalization calculations. The latter issue, along with accounting for the costs of tax collection in equalization, have theoretical strengths but practical difficulties.

Finally, an area of great controversy and limited consensus has been the treatment of resource revenues in equalization, with particular emphasis on the rate of inclusion. Policy analysts have collectively proposed the entire spectrum of resource-revenue inclusion rates from 0% to 100%. There is also considerable disagreement on the nature of particular groups of resource revenues: some analysts advocate distinction in the treatment of renewable and non-renewable resources while others argue that there is no fundamental difference.

We hope that this review has helped the reader to appreciate the extreme difficulty and complexity involved in developing a feasible and politically viable set of reforms for equalization. Nevertheless, the discussion in this chapter lays the foundation for the recommendations outlined in the next chapter.

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Solutions for equalization

Fred McMahon and Jason Clemens

Canada is in a unique position today to re-evaluate equalization in a fundamental way. The unraveling of the previous system of equalization and the commitment of the current government to a renewed system means that there is a genuine opportunity for reform. Unfortunately, the debate and discussion is not about whether there should be equalization. Rather, the debate is focused on whether we as a nation can improve upon the existing system without dismantling it. The authors of this chapter as well as many others involved in this book are convinced that a more fundamental debate about the very existence of equalization is necessary. However, it is also important to capitalize on the current opportunity to achieve incremental improvements to equalization and to instigate a broader discussion. This chapter is aimed at providing workable improvements to the system of equalization as it now exists without conceding the equally important need for a broader and more fundamental discussion of equalization and fiscal federalism.

Background

Policy motivation for regional programs

Any “solutions” chapter in public policy should begin with a clear discussion of whether there is a “problem”—in this case, whether a policy instrument is meeting its goal—and, if not, how changes could address the problem. The equalization program is part of a broader set of regional policies in Canada.

These regional policies have two inter-related goals, which are set forth in Canada's constitution. The first goal is to increase prosperity and bring the "have-not" provinces up to the national level of prosperity. This is set out in Section 36(1) of the *Constitution Act* of 1982.

Without altering the legislative authority of Parliament or of the provincial legislatures, or the rights of any of them with respect to the exercise of their legislative authority, Parliament and the legislatures, together with the government of Canada and the provincial governments, are committed to

- a. promoting equal opportunities for the well-being of Canadians;
- b. furthering economic development to reduce disparity in opportunities; and
- c. providing essential public services of reasonable quality to all Canadians.

However, the last statement, 36(1c), is more closely related to the second goal of Canada's regional policies as laid out in Section 36(2) of the *Constitution Act*: "Parliament and the government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation."

The equalization program is meant to address this goal. Poorer provinces typically have a smaller per-capita tax base than richer provinces. Equalization payments are meant to enable these poorer governments "to provide reasonably comparable levels of public services at reasonably comparable levels of taxation."

The first goal, as set out in section 36(1) of the Constitution, has typically been addressed by a variety of regional economic development programs, such as those run today by the Atlantic Canada Opportunity Agency (ACOA) and Federal Organization for Regional Development—Quebec (FORD-Q).

The two constitutional goals are inter-related. Achieving the first, increasing prosperity for all Canadians, particularly in the "have-not" provinces is the fundamental aim of Canada's regional policies. To the extent it is possible to bring all the provinces up to roughly the same economic level, achievement of the first goal would reduce policy action required to achieve the second goal. Meanwhile, equalization itself could in principle contribute to economic development by providing comparable levels of public services across the country at a comparable cost to businesses and individuals.

Our discussion will necessarily focus on whether these programs meet their explicit aim of helping “have-not” provinces. Programs need to be judged by whether they succeed at what they are designed to do, and so this section will briefly examine whether regional programs meet their stated goal.¹

Fiscal federalism

Because of the interconnectedness of regional goals and how they are reflected in fiscal federalism, it is important to examine them in relation to the overall structure of fiscal federalism rather than in isolation as so often happens in policy debate in Canada. This leads to the fundamental question: are Canada’s regional programs achieving their stated aims or is there indeed a problem to be solved? A subsidiary, but crucial, question is: how do the policies meant to achieve these goals interact? That is, are these policies mutually supportive or do their interactions produce perverse results?

Let us look first at 36(2), the motivation for equalization. Equalization is a relatively small part of Canada’s fiscal flows. To obtain an understanding of the impact of equalization, it is necessary to look at it in the context of overall fiscal flows. Equalization is intended to help poor provinces, but the rest of federal spending is hardly doled out on an equal per-capita basis across the country. There is discretionary direct federal spending that may benefit one province more than another; the structure of some programs may create unequal direct spending among the provinces in these programs; and an “equalization” element is contained in a number of federal transfers to the provinces.

The federal government’s recent Expert Panel on Equalization and Territorial Formula Financing (EPETFF) expressed frustration that its mandate prevented it from examining the overall structure and impact of fiscal federalism. The panel argued that at least some elements of fiscal federalism affected equalization and that policy recommendations should also address these elements. It also noted a problem we will be discussing, over-equalization,

1 Although, for this reason, the pan-Canadian aspects of regional programs are of less interest to us here, they have been examined elsewhere. McKinnon (2005), for example, argues that the transfer of resources out of Ontario leaves the provincial government in the position of either not being able to provide services comparable with those in “have-not” provinces or of raising taxes to a level that would be uncompetitive with Ontario’s competitors, particularly neighbouring American states. The argument is that federal taxes take up so much tax room that Ontario is unable to fund provincial services properly from the tax room left the provincial government and that federal transfers to the provincial government, which are considerably smaller on a per-capita basis than those to have-not provinces, are inadequate to make up this shortfall.

the idea that the flow of federal funds to “have-not” provinces can produce higher levels of services in these provinces than available in “have” provinces despite similar tax rates.

As if the Equalization program isn’t complicated enough on its own, other federal transfer programs, particularly the Canada Health Transfer and the Canada Social Transfer, also include an equalizing component. These programs provide federal funding to provinces through a combination of per-capita cash payments and tax points. The result is that wealthier provinces like Ontario and Alberta receive lower cash payments than other provinces. There is a designated component (called Associated Equalization) that provides payments to provinces to equalize tax points as part of the Canada Health Transfer and the Canada Social Transfer.

Furthermore, under these transfers, if a province’s fiscal capacity increases to a point where it is no longer eligible for Equalization, that province actually receives more in per-capita cash transfers through the Canada Health Transfer and the Canada Social Transfer to compensate for the fact that it no longer receives Equalization funding for its share of the tax point transfer.

The result is confusing at best and adds yet another layer of complexity to the process. It amounts to “back door” equalization and is an ongoing source of irritation both on technical grounds and in principle. It is beyond the Panel’s mandate to recommend a specific solution; however, the Panel encourages the federal government and the provinces to address this issue so that Equalization is the primary vehicle for equalizing fiscal capacity across provinces. (EPETFF, 2006: 47)

The Advisory Panel commissioned by the Council of the Federation expressed amazement at the complexity of the system and, remarkably, the experts on the Panel acknowledged they had “discovered” an equalization program of which they were unaware. “In the course of its work, the Panel discovered a supplementary program of equalization ... First, as we have described, there is associated equalization, with tax points equalized through the application of the five-province standard that governs the equalization formula. Finance Canada then takes a second step. It equalizes again, this time to the top-province standard” (2006: 70). Even more perversely, under current programs, if a province no longer qualifies for equalization (in other words, if its fiscal capacity equals the five-province standard), then its federal transfers can actually increase (EPETFF, 2006: 47).

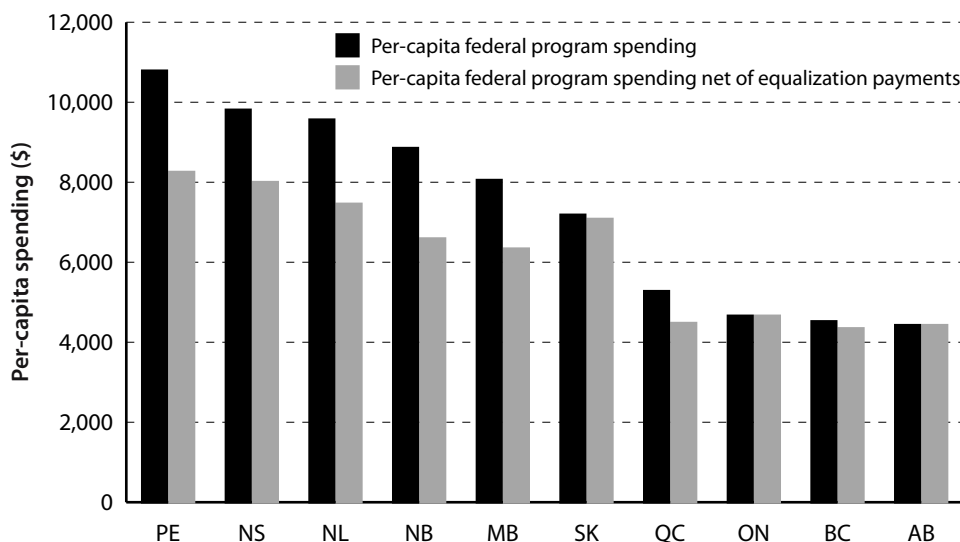
Canadian fiscal flows have been comprehensively discussed elsewhere in this volume (see page 4) and that discussion will not be repeated at length. However, it is worth noting that the distribution of federal spending is heavily skewed even when equalization payments are netted out from federal spending (see figure 5.1). Instead of there being one policy instrument to meet the goals of Section 36(2), there a number of overlapping policies, including direct federal subsidies for programs under provincial jurisdiction. Thus, it becomes very difficult to determine if equalization, and the numerous other policies that interact with equalization, carry out the task assigned to equalization.

Difficulty in determining whether a policy is succeeding or not is itself a sign of policy failure. However, there are signs of a deeper failure, that instead of “equalizing” fiscal capacity so that provinces are able to provide comparable services at a comparable costs, the program is actually creating further imbalances, over-equalization, and thus fails to achieve the goal of equalization as outlined in Section 36(2) (see chapter three).

Policy impact

The question then arises whether equalization contributes to the other and primary goal of Canada’s regional policy, furthering economic development in poorer provinces. In fact, there is evidence that the vast fiscal flows towards the poorer provinces, to which equalization contributes, damages economic growth in these provinces (McMahon, 2000).

Figure 5.1: Per-capita federal program spending (2005/06)



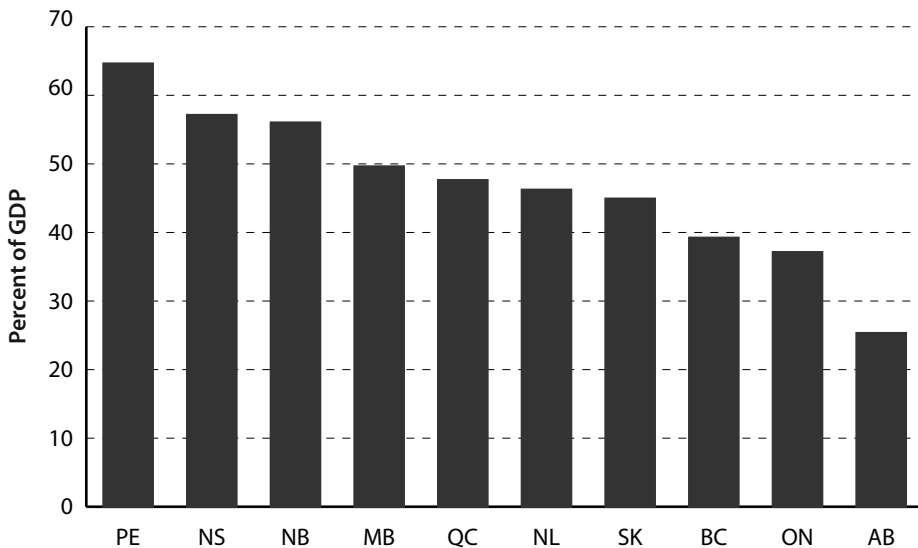
Source: Statistics Canada, Provincial Economic Accounts 2006; Statistics Canada, Financial Management System 2006; calculations by the authors.

First, massive federal transfers to the “have-not” provinces have built up a huge government sector (Figure 5.2) that effectively crowds out private-sector activity, thus reducing economic growth while increasing dependency. The problem is described in a study sponsored by the Atlantic Canada Opportunities Agency (ACOA) and the Government of Nova Scotia.

[A] significant proportion of the Nova Scotia firms visited were partially dependent either directly upon provincial or other forms of public purchasing or indirectly through subcontracting to larger firms which are in turn reliant upon government spending for their survival and profitability ... *Public policy appears inadvertently to have reinforced market failure to some extent by cushioning profits via grants, subsidies and preferential purchasing thereby reducing the incentive to change ...* The heavy reliance upon Federal transfers has indirectly promoted a dependency culture in the province ... a culture, as one owner manager said of “a whole region being on the dole.” (O’Farrell, 1990: 24–25; emphasis in the original)

Second, not only does the overall set of programs have an adverse affect on the business sector but it also appears to have a strongly negative impact on the labour market and employment in “have-not” provinces, thus again

Figure 5.2: Federal, provincial, and local government spending (% of GDP) (2005/06)



Source: Statistics Canada, Provincial Economic Accounts 2006; Statistics Canada, Financial Management System 2006; calculations by the authors.

reducing economic growth. Here the chief culprit is the Employment Insurance system and its regionally extended benefits. Prior to the introduction of regionally extended benefits in 1971, all three of the old Maritime Provinces (excluding Newfoundland) had experienced at least one year of unemployment below the national level. After the introduction of regionally extended benefits, unemployment in Atlantic Canada jumped to about four percentage points above the national average. Despite this, the Unemployment Insurance (as it was then called) was so generous that both the Atlantic Provinces Economic Council and Statistics Canada began reporting labour shortages, including shortages of unskilled workers, in the region (Riddell, Kuhn, Clemens, and Palacios, 2006; Kuhn and Riddell, 2006; McMahan, 2000: ch. 5; Grubel and Walker, 1978).

Thus, there is little evidence that equalization as it is structured, either under the New Framework or prior to October 2004, is meeting the overall goals of regional policy and considerable evidence that it is producing perverse policy results not only on equalization, which includes a number of “equalizing” elements aside from equalization, but as well on the primary goal of Canada’s regional policy, to spur economic development in poorer provinces.

Principles of good policy

As noted elsewhere, there is an argument for dropping the equalization program altogether but, given that some form of equalization is enshrined in the Constitution, the purpose of this study is to make recommendations to improve equalization.² However, as the federal government’s Expert Panel on Equalization and Territorial Formula Financing notes: “There is no perfect solution for Equalization in Canada. Given the dynamics and diversity of Canada’s federation, perfection will undoubtedly continue to elude all of us” (2006: 6). The recommendations below note the trade-offs that are involved.

Primary principles

- 1 The first and most obvious principle is that equalization and related programs should be designed to meet the goal stated in Section 36(2) of the *Constitution Act*, “to ensure that provincial governments have sufficient revenues to

2 A credible argument can be made that Section 36(2) conflicts with the constitutional delineation of federal spending powers; see chapter two, pages 25 ff.

provide reasonably comparable levels of public services at reasonably comparable levels of taxation.”

- 2 The larger goal is promoting growth in poorer regions, as stated in Section 36(1). Equalization to the extent possible should be designed not to undermine this pillar of Canada’s regional policy.

Subsidiary principles

- 1 Policy structures that have led to over-equalization and the crowding out of the private sector should be eliminated or reformed.
- 2 Equalization should be the sole vehicle for equalizing fiscal capacity among the provinces; otherwise transparency is reduced and the possibility, indeed the likelihood, of over-equalization arises.
- 3 Equalization should be based on a ten-province standard.
- 4 Equalization should be predictable.
- 5 The equalization system should be rules based.
- 6 Equalization should be structured so that it will not give a recipient province greater fiscal capacity than any contributing province.
- 7 The equalization program should be based on general principles of good policy.
 - a Those affected by equalization should not be able to “game” the system to achieve greater rewards than the program merits while reducing the rewards for others.
 - b The system should not introduce “perverse incentives” that can undermine the purpose of the program or other policy objectives.

The two principles above mean, in effect, that the equalization should be policy neutral and not cause a province to implement, eliminate, or alter policies if it would not have done so in the absence of equalization.

- c The policy should meet the related goals of transparency and simplicity.

Two key recommendations

The recommendations presented in this section go well beyond the standard ideas for reforming equalization, which typically return equalization to the type of policy framework in place prior to October 2004, usually with minor changes, such as a cap, or with other changes, such as resource calculations, reducing the number of tax bases, or adopting the 10-province standard. None of those recommendations solve the deeper structural problems that arise from the interaction of equalization with other aspects of fiscal federalism and have created the perverse policy results discussed above.

This section presents two key recommendations that would change the structure of equalization and enable it to achieve the goals set forth in the Constitution much more efficiently and fully.

1 Remove the federal government from areas of provincial responsibility

The overall structure of fiscal federalism has led to the problem of “over-equalization” and the associated problem of crowding out private-sector activity. This recommendation will go a long way towards eliminating these failings. The federal government should vacate areas of provincial jurisdiction, end federal-provincial transfers in these areas, and return an equivalent amount of tax room to the provinces.

What this would mean is that there would be primarily one transfer program, not a complex of interlocking programs, designed for equalization and obviously that would be the equalization program. It would, at a stroke, end the “equalization” components of most other transfers to the provinces and allow the equalization program itself to be better calibrated, since the effect of the program itself would not be confused by the impact of overlapping programs.

Equalization now accounts for only about a quarter of all federal transfers. So long as an interlocking web of programs contributes to equalization, the equalization program itself will never actually “equalize” unless it incorporates the calculations and fiscal and related effects of all other programs contributing to equalization, a system of unimaginable complexity (see chapter one, pages 3 ff.). The obvious solution to this problem is to make equalization the sole program responsible for equalization. That result is largely achieved by the recommendation that Ottawa remove itself from provincial areas of responsibility.

Aside from the positive impact on equalization, there are a number of reasons for such a shift in policy. As the Council of the Federation notes: “The Government of Canada’s practice of making unilateral decisions that have

a powerful impact on provincial governments corrodes the relationships of trust and the networks of collaboration and mutual respect that are so vital to the healthy function of the federation” (2006: 10).

The proposal presented in chapter one goes further than the Council and fundamentally restores the link between taxation and responsibility (see also Harris and Manning, 2005a, 2005b). It ends the dual federal-provincial responsibility that has enabled both levels of government to resort to finger-pointing rather than problem solving, particularly in the area of health. And, it brings the full management of these programs to the level of government closer to the people.³

Finally, it should be noted that this proposal could increase the size of payments within the equalization program itself. Without federal transfers to support programs such as health, the provinces would have to rely on their own fiscal resources. The fiscal capacity of “have-not” provinces is typically lower than that of richer provinces. This may result in increased equalization though the program would have to be modeled completely to determine the actual impact on payments.

2 Base equalization on the cost of providing services

The current equalization program implicitly assumes that the cost of providing services across Canada is similar if not identical. This is manifestly false. It clearly costs more to provide services in Toronto or Vancouver than in New Glasgow or Saskatoon. The constitution does not require that provinces receive equal revenues but rather that they be able to provide reasonably comparable services at reasonably comparable levels of taxation.

In general, the cost of living and of providing services will be lower in poorer provinces than in richer ones. Statistics Canada produces detailed data on the cost of living across Canada, both by province and by sub-provincial areas, though not all of this data is publicly available.⁴ Equalization payments

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- 3 However, a caveat must be added here. While this proposal would go some way to dealing with the problem of government over-spending in “have-not” provinces, the positive effect would only be complete if both regionally extended Employment Insurance and Ottawa’s menu of “economic development” programs were sensibly reformed.
 - 4 Statistics Canada collects the prices of over 600 goods and services that it uses to compute the Consumer Price Index (CPI). Over 60,000 price quotes are obtained by Statistics Canada across Canada in both urban and rural areas on a monthly basis. In late 2006, researchers from The Fraser Institute attempted to obtain the price data underlying the CPI but were told that Statistics Canada does not make it available to the public.

should be adjusted according to the cost of providing services. For example, if it costs 95% of the average cost of delivering services in a province receiving equalization, the calculation of the equalization payment should be adjusted downward by this factor. Similarly, if it is more costly in a province receiving equalization to provide services, perhaps due to distance, the payment should be adjusted to reflect this.

While the principle here is clear, a number of details will need to be worked out. For example, at first approximation the overall cost of living should be used for this calculation as a proxy for the cost of providing services but it may be more appropriate to provide weighting by specific components such as labour and property. Costs also vary between urban and rural areas. It will be essential to ensure that data from Statistics Canada provides either an appropriate provincial average to account for this or enough regional information to enable proper weighting across each province.

Clearly, if the costs of providing services are not included in the formula, then equalization in a low-cost province could enable the province to provide services superior to those of a contributing province with comparative level of taxes, while the reverse would be true in a province with high costs. This is contrary to the goals of equalization.

This adjustment may not make a large initial difference. Canada's collection of regional programs has boosted the cost of living in Canada's "have-not" provinces, particularly through the rise in civil-service wages brought on by "public sector capture" (McMahon 2000: ch. 5). Artificially high costs in these provinces would also have a negative impact on the other regional goal of increasing prosperity in these provinces since increased costs will deter investment. Sensibly structured regional programs would relieve at least some of the pressure of artificially high costs and not only boost economic growth but likely lead to a slight downward shift in the cost of equalization over time by both reducing the cost of providing services and increasing growth and, thus, fiscal capacity.⁵

Use a Macro approach, not the Representative Tax System

The Representative Tax System (RTS) used to calculate equalization payments is a major flaw in the current equalization program. We recommend that a macro approach for calculating equalization be examined and an operating

5 Of course, if the overall goal of regional programs were met, the cost structure of poorer provinces would increase as they gain prosperity but so too would their fiscal capacity.

system devised to give policy-makers an alternative to the RTS. A detailed investigation will be required to determine whether a macro approach can avoid the problems of the RTS or whether it would introduce new problems.

A macro approach would use macro variables, such as Gross Domestic Product (GDP) per capita or personal income per capita, or a combination of these and other macro variables, to estimate a province's fiscal capacity. A macro approach has been suggested by a number of Canada's leading scholars such as Boothe and Hermanutz (1999) and Usher (2005). We recognize that this approach has flaws, which we will discuss, but we believe that these flaws are likely to be less burdensome than those imposed by any RTS.

The federal government's Expert Panel on Equalization and Territorial Formula Financing recommends a return to the Representative Tax System as the method of calculating equalization (EPETFF, 2006). It rejected the use of "Macro Formula" but acknowledged the strong attraction of such an approach. We believe that, judged by principles of sound policy, a macro approach, while it has some pitfalls, is superior to the RTS approach.

Complexity of the Representative Tax System

A significant problem with the RTS is its complexity. Governments are innovative taxers. They are constantly finding new tax bases and fiddling with existing ones. This makes the RTS an inherently complicated and unstable system. The Expert Panel described the instability and variability of the RTS system in practice. We regard these flaws as inherent to the system for the reasons discussed elsewhere in this volume.

A macro approach would also be complex. How complex? The Expert Panel notes a key problem: macro variables do not necessarily translate directly into tax capacity (EPETFF, 2006: 90). It will be difficult to develop a macro approach that accurately reflects taxation capacity. However, as the Expert Panel notes, it is theoretically possible.

If this challenge can be resolved, a macro approach is unlikely to be more complex than an RTS and very likely less complex. The Expert Panel recommends a simplified RTS system of five tax bases but the history of the system itself suggests this will be an illusive goal. The first version of the tax-based system was introduced in 1957; it used only three tax bases. Efforts to fine-tune the system and make it fairer progressively increased the complexity and number of tax bases involved. Even after the system largely stabilized in its basic approach after 1982,

the formula became increasingly complex through a series of technical adjustments discussed by federal and provincial officials or added at the

discretion of the federal government. New tax bases were added (particularly in relation to natural resource revenues), ceilings and floors on the total amount of Equalization were added, and adjustments were made in how provinces' revenues were estimated and payments were made. (EPETFF, 2006: 21)

Assuming that yesterday's civil servants and politicians are as competent as tomorrow's, this speaks to an inherent complexity and instability in the RTS.

However, while there are dozens of tax bases, hundreds of taxes, and virtually infinite ways to re-jig them, there are relatively few macro variables. Revisions to methodology are common but their purpose straightforward—to bring the accounting in closer accord with what it is supposed to measure. Moreover, the measurements are in the hands of impartial statisticians whereas the tax structure is controlled by politicians with any numbers of conflicts over its structure. The possibility of a macro approach increasing pressure to politicize Statistics Canada should not fully be discounted but most of the key numbers it produces already have large political significance and have not resulted in Statistics Canada's corruption.

However, while we can show that a macro approach in principle performs better than an RTS, we must acknowledge that a considerable amount of research is necessary to get there. We, therefore, call on the federal government to create a panel of apolitical experts to produce a technical report on a macro approach. This is essential to policy formulation in this area. At present, we have only one operational model available, that of the RTS. The creation of an alternative operational model will enable policy-makers to determine whether the theoretical advantages of a macro approach can be translated into reality.

Gaming

Other chapters of this report have discussed how provinces can game the equalization system with dodges like adjusting tax levels depending on the percentage of the base tax that the province accounts for nationally or hiding tax bases. Various forms of the RTS system have been tested and adjusted over the decades and each adjustment has either perpetuated existing opportunities for gaming or created others. Given that provinces will always have the right to set and structure their own taxes, any RTS system will open the door to gaming and this will remain an inherent and deep problem for any RTS.

While a province is in full control of its tax system and, therefore, well positioned to game any equalization formula based on a tax system, its direct control of macro variables is highly limited, particularly in the short-term that

is so politically important to governments. Thus, gaming the system becomes very difficult particularly when compared to gaming in an RTS.

Perverse Incentives

The RTS has a well-known tendency to create perverse incentives to forego or alter economic activity that would cause an increase in tax revenue that would be largely offset, or even cause a loss in provincial revenues, due to losses of equalization payments. An example, developed earlier in this study, concerned natural resource revenues for Saskatchewan (see chapter 3, pages 47 ff.). As well, an RTS can create incentives for a province to increase taxes on bases in the RTS formula. This will cause activity to shift to other regions or to more lightly taxed activities in the same province. The tax loss will be compensated by equalization. Smart finds average tax rates in receiving provinces were substantially higher as a result of this incentive (2006; see also Snoddon, 2003).

Here again, the RTS is flawed since, by its nature, it demands a “claw back” of new or increased provincial revenues. The multi-year rolling average to some extent mitigates the problem—particularly during periods of brief price spikes—but since revenues, like those from potash or nickel, are themselves typically multi-year revenue sources, it does not solve the problem.

Under a macro approach, the practicality of acting on perverse incentives is markedly reduced. The perverse incentive under a macro system is quite similar to that under an RTS and, in theory, a provincial government would have an incentive to reduce provincial GDP or other relevant macro variables in order to increase equalization payments. However, if a macro system is correctly calibrated to represent fiscal capacity, increases in equalization would only offset losses in taxation capacity, while the provincial government would have to bear the political cost of adverse economic effects on, say, unemployment.

The problem of measurement

The challenge will be to develop an overall “macro” estimation of the taxation capacity of an economy. In theory, it would be possible to devise a “macro” approach that replicated the results of the “micro” RTS, in other words, to find macro variables that, when appropriately adjusted, would track the taxation capacity of those taxation bases included in an RTS. Such a system would be no improvement and duplicate all the problems of an RTS system.

But this challenge also points to another way in which a macro approach would be superior to an RTS. Clearly, the RTS is meant to be a measuring device for determining fiscal capacity. Yet, it ignores the first principle of

measurement: the measurement device should be independent of the result. In other words, your car speedometer should not affect the actual measurement of your speed of travel. If your car is going 60 kph, the speedometer should register “60,” regardless of how the speedometer is constructed. But, the very construction of the RTS affects its measurement of fiscal capacity. An RTS that is weighted towards income tax will show a higher fiscal capacity in a province with many wealthy retired persons but few corporations than an RTS weighted towards corporate taxes. No RTS is just based on one tax but the determination of which taxes are included in the RTS will affect the measurement the RTS is attempting to make.

An appropriately constructed macro system should provide an overall estimate of the taxation capacity of a province. This would support federal policy-neutrality in areas of provincial jurisdiction by avoiding RTS-based incentives to increase or decrease taxes on a particular base.

Other considerations

A macro approach would help address issues that continue to vex the experts in equalization: property taxes, user fees, debt gaming, and resource revenues. The first three of these challenges would largely disappear under a macro system. A macro system would not consider property taxes or user fees and would make the gaming of borrowing and spending impossible.

All RTS approaches to handling resource revenues are simply arbitrary. This is because resource royalties can be so large as to distort provincial revenues substantially. Thus, the question arises: What percentage of resource revenues should be included in the calculation of equalization under an RTS? Politics plays a great role in answering this question. Provinces like Newfoundland and Alberta that are rich in resources would like to see resource revenues excluded; provinces like Ontario or Prince Edward Island that are relatively poor in resources would want them fully included. So, should it be 100% or zero percent of resource revenues; or a compromise like 75% or 50% or 25%. The Expert Panel suggests 50% but bases this primarily on a simple judgment; perhaps, it just seems to feel right as a Canadian compromise. This is not meant as a criticism of the Panel. Under RTS, resource revenues become an intractable problem and the Expert Panel itself notes that there is “no magic number.”

But, revenue from resources becomes much less of a problem under a macro approach. Resource revenues contribute disproportionately to tax revenues and less to overall GDP. Thus, it seems likely that resource sectors could be fully considered under a macro system, though this deserves thorough investigation in the research that we have called for. This, in effect,

discounts resource revenues, as the Expert Panel and others recommend, but does not do so in an artificial way based on the arbitrary selection of one “magic” number.

The challenge

It may be that the development of a macro approach, particularly one that avoids the problems associated with the RTS, will face intractable difficulties. The only way to determine that is through a research effort to develop the system. We have argued in this section that the RTS both directly and indirectly creates difficulties that undermine some of the goals of Canada’s regional policies and create other economic problems. It is worth making the effort to determine whether a functional macro approach can be designed.

Other recommendations

Cap equalization

We endorse the principle stated by the Expert Panel that a “cap should be implemented to ensure that, as a result of equalization, no receiving province ends up with a fiscal capacity higher than that of the lowest non-receiving province” (EPETFF, 2006: 7). Although easy to state and understand, this is an extremely important recommendation. Clearly, without such a cap, the equalization program can work at cross purposes to its own goals, if the program is structured to permit such overpayments.

The concept of a cap has found considerable support within the policy community but it remains controversial politically, in that a receiving province that might end up with a fiscal capacity above that of a non-receiving province would like to maintain that extra fiscal capacity. It should be noted that a properly structured macro approach should eliminate the problem, but it does underline the need to carefully investigate and build the macro structure, model it, and compare it to RTS outcomes prior to implementation.

The ten-province standard

Given that the goal of equalization is to allow all provinces to provide reasonably comparable services at reasonably comparable levels of taxation, the five-province standard has never meshed well with the stated goals of the equalization program. The ten-province standard should be re-established, whether an RTS or a macro approach is used.

Predictability

Equalization payments can fluctuate widely for several reasons. This creates instability and uncertainty in the budgeting process. Two key causes are behind the fluctuations. Firstly, provincial revenues themselves can vary considerably due, for instance, to changes in natural resource prices. The Expert Panel recommends that payments be based on a three-year moving average using two-year lagged data. The multiyear approach would smooth out fluctuations and we endorse it. For a number of reasons, fluctuations would likely be smaller under a macro approach, but the need for predictability still makes using a multi-year average a good idea.

Secondly, revisions to data can be quite large and lead to significant adjustments in equalization payments (requiring repayments from the provinces or additional payments to them) up to 30 months later. Short of developing a way of creating immediately accurate data, there is no perfect solution for this problem. However, as a lesser of two evils, we recommend that the initial payment remained locked in place in order to bring stability and predictability to the system. The Expert Panel calls this the “one estimate, one entitlement, one payment approach” (2006: 7).

Return to a rules-based system

In 2004, the federal government and the governments of Nova Scotia and of Newfoundland and Labrador entered into “side deals” that affected the impact of resource revenues on equalization. Such side deals not only can have large effects on equalization payments that are unrelated and sometimes contrary to the intended purpose of equalization but are intended by their participants to do so.

A “New Framework” for equalization and Territorial Formula Financing (TFF) was announced in October, 2004. This system, which was no longer rule based, set in place a fixed equalization pool, a guarantee that no province’s equalization payments would decline from the amount announced in the 2004 budget, a guaranteed growth rate of 3.5%, and fixed shares for the provinces set out two years in advance.

Clearly, none of these measures necessarily represented the relative fiscal capacity of the provinces, thus separating equalization as a program from the goals it was established to achieve. As the Council of the Federation noted: “The federal government’s 2004 New Framework for Equalization, with its fixed pool of money and fiscal escalator has broken the link between the redistribution of equalization funds and the relative fiscal capacities of the provincial governments” (2006: 16). For example,

under the “New Framework,” these side deals would provide Newfoundland and Labrador, as a large recipient of equalization, with fiscal capacity greater than that of Ontario, whose taxpayers are the main contributors to equalization.

Equalization should be returned to a rules-based system—either RTS or, preferably, a macro approach—specifically designed to meet the goals set forth in the Constitution. Side deals affecting equalization payments should be abandoned.

Debt payments and heritage funds

Both debt repayment and transfers to heritage-type savings funds remove monies from the current spending stream. For this reason, it has been argued that both should be subtracted from tax revenues when calculating equalization. This argument could apply to a macro approach but it might not be necessary to make such an adjustment. A contribution of, say, \$100 million to a heritage fund could have a large impact on a province’s revenue stream if the contribution were subtracted from revenues; but it would likely have a much smaller effect on GDP if the contribution were subtracted from overall GDP. The precise scale would be a modeling issue but clearly the subtraction of \$100 million from a province’s revenue stream is a larger proportion than subtracting \$100 from a province’s GDP, unless a province’s revenues are as large or larger than GDP, which is theoretically possible but unlikely, even in Canada.

We recommend against such adjustments if a macro approach is employed. Firstly, as noted, a shift to a macro approach would eliminate much of the problem by scaling down the impact of the adjustment. Secondly, and more importantly, we believe any system of equalization should be as policy neutral as possible. We have argued elsewhere that Ottawa should restrain from using its fiscal power to interfere in areas of provincial responsibility. Including such adjustments in the equalization formula would violate this principle by creating, for example, an additional incentive for a province to set up or increase a heritage fund.

Nonetheless, we believe that these adjustments should be made if the RTS continues. The RTS provides perverse incentives for provinces to use debt financing and that also violates the neutral policy stance we believe the federal government should adopt. We, therefore, believe the adjustments would be sensible policy under an RTS and, if anything, have a higher degree of neutrality than not making the adjustments.

Summary of recommendations

- 1 Make the equalization program the sole agent of equalization through federal transfer payments by removing the federal government from areas of provincial jurisdiction.
- 2 Adjust equalization payments to the cost of providing services.
- 3 Create a high-level, apolitical panel of experts to investigate a macro approach for equalization calculations.
- 4 Cap equalization.
- 5 Return to a 10-province standard.
- 6 Increase predictability.
- 7 Return to a rules-based system.
- 8 Make no adjustment for debt payments and heritage funds under a macro approach but adopt these adjustments if the RTS remains in place.

We believe these reforms, in combination with the other changes we recommend, will return the equalization program to goal defined in the Constitution. At the same time, it will reduce the negative economic effects of over-spending by government in poorer provinces, which frustrates the primary goal of Canada's regional policy, to increase prosperity in "have-not" provinces.

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