



EQUALIZATION REFORMS: CONSENSUS AND DISAGREEMENTS

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Equalization is a major federal program designed to transfer tax dollars from the “have” to the “have-not” provinces. Since its inception in the mid 1950s, the program has been based on the principle that all Canadians should have access to reasonably comparable public services financed by reasonably comparable tax levels. However, in recent years, the efficacy of the equalization program in achieving its national purpose has been called into question, especially following the implementation of the New Framework¹ and several high profile side agreements.² In response, the Council of the Federation (a provincial organization based in Ottawa) and the federal government have undertaken major reviews of the equalization program with the goal of reestablishing a functioning equalization system. (For a comprehensive outline of these recommendations, see Clemens and Harischandra, 2007). It is widely anticipated that the federal government will announce a new equalization program early in 2007.

The Expert Panel on Equalization and Territorial Formula Financing was commissioned by the federal government in 2005 to review and assess the existing equalization program and provide recommendations for reform. (For further details on the expert panel’s report, see Expert Panel on Equalization and Territorial Formula Financing, 2006.) The panel, which released its report in June 2006, offered 18 major recommendations to overhaul the existing equalization program.

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At the same time, the Council of the Federation commissioned an independent advisory panel to examine, assess, and provide recommendations regarding Canada’s potential fiscal imbalance—a mandate much larger



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than that of the expert panel (for further details, see Council of the Federation, 2006) The advisory panel assessed both imbalances in the finances between the provinces (horizontal imbalance) as well as imbalances between the federal government and the provinces (vertical imbalance).

Although the two panels agreed on a number of areas of reform for equalization, others remain unresolved. The following article

outlines the major areas of consensus and disagreement in order to highlight the extreme difficulty of achieving both a functional and politically viable set of reforms.

Areas of consensus

1) Need for a formula based approach

One of the most fundamental reform proposals that both panels agreed

upon was the recommendation for a return to a formula-based approach to calculate equalization. Prior to 2004, the equalization program was based on a formula to calculate payments to the provinces that received equalization payments as well as the total cost of the program. (For a discussion of the equalization program before 2004, see Harischandra and Veldhuis, 2007.) The formula-based system, better known as the Representative Tax System (RTS), used average tax rates and tax bases in a formula to calculate provincial equalization 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. Both government panels recommended a return to a formula approach that was based on clear, transparent rules and accounted for the financial situation of the provinces.

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2) Revenue-raising capacity

Another critical area of consensus was that equalization should be based on the revenue-raising capacity (fiscal capacity) of provinces. This recommendation was in response to the suggestion by several academics and policy analysts who advocated a needs-based system for equalization that explicitly accounted for differences in the costs of delivering public services across provinces (for further details see

Clemens and Harischandra, 2007). In their report, the expert panel argued that it was impractical for the equalization program to include a measure (or measures) adjusting payments based on differing costs of delivering services given the absence of a comparable measure of provincial services and costs.

3) 10-province standard

A related, mutually agreed-upon recommendation was the adoption of a “10-province standard.” From 1982 to 2004, equalization payments were calculated based on the average revenue-raising capacity (fiscal capacity) of five provinces: Ontario, Quebec, Manitoba, Saskatchewan, and British Columbia. To ensure a fair representation of provinces, both panels recommended returning to a calculation of fiscal capacity based on all 10 provinces instead of a select few.

However, a major concern with adopting a 10-province standard was its impact on the total cost of the program. Since a 10-province standard might increase the total cost beyond what the federal government was prepared to pay, both panels 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’s cost become excessive.³

4) Predictability

Ensuring the predictability of equalization payments for provinces

was also an important area of consensus. Both panels recommended 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 to account for information constraints.⁴ The panels felt that these measures would ensure provinces have a greater degree of certainty in their equalization receipts.

Disagreements

Although both panels agreed on a number of reforms, two prominent issues remain unresolved: the treatment of natural resources under the equalization program and the structure of the Representative Tax System (RTS).

1) Treatment of natural resources

The proportion of natural resource revenues included in equalization is a critical and heavily-debated aspect of the reforms since it influences both individual provincial receipts and total program cost. (For a thorough review of the different scholarly proposals, see Clemens and Harischandra, 2007.) After a careful consideration of alternative proposals, the expert panel advocated for 50 percent of all natural resource revenues to be included in the equalization calculations. The panel's rationale for partial inclusion embodies the following criteria: (1) provincial governments have a constitutional right of ownership of natural resources and 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 public infrastructure costs incurred in resource development.

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In contrast, the advisory panel recommended that 100 percent of natural resource revenues should be included in the equalization calculations to meet the required criteria of fairness and transparency.

Interestingly, while the two panels disagreed on the issue of what proportion of resource revenues to include, they both agreed that the revenues should be included to some extent.

2) Representative Tax System

Although both government panels supported the use of the Representative Tax System (RTS) approach to calculate equalization, they did not agree on the tax categories used in the equalization calculations. The expert panel acknowledged that the RTS was overly complicated and difficult to understand. To streamline the system, the panel 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. The advisory

panel, however, did not recommend abandoning the status quo of using 33 tax bases in the calculations.

Conclusion

Equalization reforms are an important but very contentious area of federal-provincial relations. The growing awareness of the problems associated with equalization led to two major reviews by government-commissioned panels in 2006. Although both panels agreed on some reforms, other issues remain largely unresolved, particularly those concerning the treatment of natural resources. The consensus reached between the two panels may indicate, to some extent, what to expect in the package of reforms the federal government may announce early in 2007. 



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Notes

- 1 The New Framework for Equalization, introduced in 2004, effectively ended the previous equalization regime that primarily depended upon a formula to determine both the total cost of the program and equalization payments to the provinces.
- 2 These side agreements include special offshore accords to ensure that

equalization payments to Nova Scotia and Newfoundland and Labrador are not reduced because of their offshore resource revenues. The accords pre-empt an underlying mechanism in equalization that reduces payments to provinces when their tax revenues increase.

- 3 Since such issues might ultimately become a political decision, the Expert Panel further 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.
- 4 The panels further recommended weighting the three years of data as follows: 50 percent, 25 percent, and 25 percent. For example, payments for the year 2007-08 would be based on an average of fiscal capacity data for 2005-06 (50 percent), 2004-05 (25 percent) and 2003-04 (25 percent).

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