



Fiscal Federalism and the Future of Canada
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Is Equalization Broken? Can Equalization be Fixed?
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questions unanswered: how badly is equalization 'broken' and how can it be 'fixed'?

The Issues

The most compelling evidence that equalization is not irreparably broken is the fact that no province disputes the principle of equalization. Instead, the debate among Canadian governments and academics is about the scope and decision-making structure of the equalization program. In terms of the decision-making structure, the Council of the Federation report recommends the creation of a First Ministers' Fiscal Council by the federal, provincial and territorial governments "as the principal institution in Canada for dealing with intergovernmental fiscal issues".⁴ Because the Council would negotiate all federal-provincial transfers every five years, it is argued that there would be "greater stability and predictability to the process".⁵ Also, the power of the federal government to make unilateral decisions about equalization and other federal transfers would be curtailed.

An even more contentious debate centers on the scope of the equalization program. Many provinces that receive equalization argue in favor of expanding the program, while provinces like Ontario that do not receive equalization contend that such enhancements are unaffordable. Thus, a key issue that has to be addressed is the extent to which equalization should address what has been called the horizontal fiscal imbalance – the "great disparity in the ability of individual provinces and territories to deliver comparable levels of services at reasonably comparable rates of taxation."

provincial government required working with other provinces on specific issues to find common ground. The lesson of the side deals was that success requires aggressive, persistent and high profile advocacy of a province's own interests, and the rallying of its electorate to its cause, rather than seeking common ground with other provinces. Hence, other provinces became more aggressive in their positions and more narrowly focused on their own provincial interests.

The terms of the side deals also led to an understandable sense of unfairness in other provinces and this was reflected in the positions taken by the provinces of Saskatchewan and Ontario. Consider the case of Saskatchewan. For years Saskatchewan has used the federal-provincial negotiating process to make its case about an equalization formula that allows claw-backs of resource revenues that have at times exceeded 100 percent.⁷ When the side deals

receiving from equalization and other transfers from the federal government. Equally important, however, will be the level of federal support for what can be considered national initiatives within the province, notably the Olympics and the Pacific Gateway Project to upgrade ports in British Columbia.

Considering the size and diversity of Canada, the task of balancing the interests of the various provinces is a task that rightly rests with the federal government and it needs to have the final say about equalization and other federal transfers and programs. But final decision-making power does not mean an unfettered capacity to act unilaterally. What the federal government has to do is build a consensus – an acceptance by enough of the provinces – that the redesign of equalization along with the changes in other transfers and federal programs is reasonably fair. Thus, the task of seeking consensus and compromise among the various provincial interests, and re-jigging equalization in the broader context of federal-provincial relations, requires the political skills of federal politicians not the technical skills of experts.

Although a fundamental change in the decision-making structure of equalization is not warranted, there is at least one other change in the governance of equalization that has merit. In its consultations, the Advisory Panel on Fiscal Balance found that some participants were concerned that “no objective criteria exist for evaluating the effectiveness of the Equalization program.”⁸ This is not a small problem for a major federal program that expends billions of taxpayers’ dollars. It could be argued that it would be difficult to find quantitative measures to assess the effectiveness of equalization since so many other factors can affect the fiscal capacity of provinces. Nonetheless, this should not be an excuse for allowing the provinces, territories and federal government to side-step their responsibility to work together to find ways to measure the effectiveness of equalization.

The Limits of Equalization: The Historical Dimension

If the short-term problems with equalization result from the ‘side deals’, the long-term problems relate to the extent to which Canada has changed since equalization was created in

the 1950s. Understanding some of these changes helps to explain a key theme of this paper: if equalization is to be ‘fixed’, then, Canadians have to become more realistic in their expectations of what the program can and can not achieve.

Equalization was established in an era dominated by Keynesian economics and by a vision of Canada that dates back to the 1939 Royal Commission on Dominion-Provincial Relations (the Rowell-Sirois Commission).⁹ Keynesian economics was based on the idea that states could engineer their own economies and establish the taxation levels required to fund social programs. The Rowell-Sirois Commission report articulated the vision of the Canadian welfare state that dominated federal policy making for more than a generation and became equated with Canadian unity. It argued in favour of a centralized taxation system that would allow the federal government to manage the economy effectively, establish programs with national standards and use what it called “national adjustment grants” to redistribute money among provinces so that similar programs existed across the country.¹⁰

For better or worse the world of Keynesian economics has passed and the vision of Canada that flowed from the Rowell-Sirois is no longer as relevant as it was a generation ago. The emergence of the global economy has meant that governments can no longer engineer their economies and their power to set taxation levels at whatever level is deemed necessary to fund social programs has been severely constrained by the need for tax rates to be competitive. The Canadian tax system has become much more decentralized both internationally and inter-provincially. Competition has led to further pressure on governments to reduce taxes. Moreover, as the cost of social programs increased and the provinces began paying a greater share of the costs, it has become increasingly difficult if not impossible for the federal government to impose national standards for such programs.

The Limits of Equalization: Ontario and Alberta

Equally important are the changes that have occurred in the two provinces that have

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since the early 1990s that Canada's largest
province is no longer its richest and it can not

economy one of the greatest challenges for governments is to understand what they can and what they can not control. Smart governments accept that there are areas in which their power to act is limited. Instead, they focus on the areas exclusively within their domain and act strategically and effectively within this sphere. Equalization is clearly a federal program, but there are significant constraints on the extent to which the federal government can use the program to address the horizontal fiscal imbalance or disparities among provinces in Canada.

The limitations on the capacity of the federal government to redistribute revenue among provinces have to be seen in the broader context of the various federal programs that can be used to address inequalities in Canadian society. There are several programs that are under the exclusive control of the federal government that can be enhanced to mitigate inequalities among Canadians. The federal government has exclusive jurisdiction over the Child Tax Benefit, a program designed to enhance the incomes and services available to low-income families with children. If the federal government wants to address inequalities among seniors it can unilaterally increase the Guaranteed Income Supplement, a federal program that provides subsidies to low income seniors. And federal student assistance programs can be enhanced to alleviate the fiscal problems of students. Thus, there are various policy tools that are exclusively within federal jurisdiction that can be used to lessen inequalities among Canadians.

Conclusion

Equalization has been an important part of Canada's political and social fabric, but its continued success requires realistic ideas about its future. As much as policy experts might want the program to be based on technical consistency and clarity, equalization and the other federal transfers and programs will become muddled by the compromises and balancing of provincial interests that are necessary in a large and diverse country like Canada. As much as some Canadians would like to see the same national programs from sea to sea to sea to sea, the diversity of Canada and the disparities in the fiscal capacities of the provinces will mean that a more modest standard will be achieved.

The noble ideal of redistributing resources from richer to poorer provinces with the goal of ensuring some comparability in the services available to all Canadians is worth preserving. However, such a goal should not be achieved at the expense of Canada's two wealthiest provinces. Ontario and Alberta remain committed to the principle of equalization. But that commitment will be sorely tested if Ontario citizens come to believe that the quality of their own services is being compromised or Albertans think that the federal government is trying to tap into resource revenues that rightfully belong to the province. Equalization, though broken, is fixable so long as there is a clear understanding of what it can achieve and what it can NOT achieve and should not even try to tackle.

Endnotes

¹ Canada, *Achieving a National Purpose: Putting Equalization Back on Track, Expert Panel on Equalization and Territorial Formula Financing*, (2006) Executive Summary, 1.

² Canada, *Achieving a National Purpose*, Equalization 101, 1.

³ The Council of the Federation, Advisory Panel on Fiscal Imbalance, *Reconciling the Irreconcilable: Addressing Canada's Fiscal Imbalance* (2006).

⁴ *Reconciling the Irreconcilable*, 95.

⁵ *Reconciling the Irreconcilable*, 96.

⁶ *Reconciling the Irreconcilable*, 9.

⁷ Courchene, Thomas J. (2004). "Confiscatory Equalization: The Intriguing Case of Saskatchewan's Vanishing Energy Revenues," *Choices*, Institute for Research on Public Policy.

⁸ *Reconciling the Irreconcilable*, 37.

⁹ Government of Canada. (1954) *Report of the Royal Commission on Dominion-Provincial Relations Book I: Canada, 1867-1939*. Ottawa: Queen's Printer.

¹⁰ *Report of the Royal Commission on Dominion-Provincial Relations*, 125-130.

¹¹ Ontario Chamber of Commerce. (2005). *Fairness in Confederation: Fiscal Balance: Driving Ontario to "Have-Not" Status*.

¹² Courchene, Thomas J. (2005). "Vertical and Horizontal Fiscal Imbalance: An Ontario Perspective," Institute for Research on Public Policy

¹³ *Achieving a National Purpose*, Executive Summary, 2.

¹⁴ Canada, *The Constitution Act* (1982), Section 36(2).

¹⁵ *Reconciling the Irreconcilable*,