



*Fiscal Federalism and the Future of Canada*  
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## **Equalization Reform in Canada Principles and Compromises**

### **I. INTRODUCTION**

After nearly fifty years of life as a formula-based program driven by evolving inter-provincial differences in fiscal capacity, Equalization was severed from its foundations in 2004 by a

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principles selected in these two reports are directed at the structure of the program and not at its *raison d'être*. I suggest that greater emphasis should be placed on the fundamental rationale for the existence of the equalization program and that this rationale is inextricably linked to our collective view of the role of government. With respect to the formula, I argue in Section III that the two reports offer compromises that, while holding back the cost of the program for the federal government, add some inequities (federal report) or facilitate discretionary decisions (provincial and federal reports). In Section IV, I suggest that there is no need for compromises if we let the program run on automatic pilot and focus on two consistent options: (a) the ten-province standard with full inclusion of resource revenues (the option preferred by the provincial Panel) and a two-stage approach that provides an explicit separation of the effects of resource revenues on total entitlements and their allocation among receiving provinces.

## **II. PRINCIPLES**

In developing a package of reforms, the

**Table 1. Principles for Reforming Equalization Listed in the Federal Report and the Provincial Report.**

<b>Principles</b>	<b>Federal Report</b>	<b>Provincial Report</b>
Consistency with Canada’s Constitution	X	X
Fairness	X	X
Adequacy	X	X
Responsiveness	X	X
Policy Neutrality and Sound Incentives	X	
Equity between Receiving and Non-Receiving Provinces	X	
Simplicity	X	
Transparency	X	X
Predictability and Stability	X	X
Affordability	X	X
Accountability	X	X
Sharing		X

While disentanglement did not imply the absence of federal transfers to the provinces, it incorporated an understanding that these transfers would decline over time as provinces developed their own revenue structures and economic growth generated the necessary tax bases for fiscal self-sufficiency. Accordingly, federal transfers to the provinces, which in 1874 had amounted to 56.7 percent of provincial revenues and 20.4 percent of federal revenues, by 1930 accounted for only 9.7 percent of provincial revenues and 3.6 percent of federal revenues.

The resilience of this type of fiscal federalism in Canada was tested by a variety of internal pressures and external shocks. The dream of unbounded prosperity that had accompanied the birth of the nation had been shattered by numerous recessions and a disastrous Great Depression while the stability of the fiscal arrangements was tested by the need to finance two world wars. The response to these shocks resulted in ad hoc changes to the original fiscal arrangements. World War I led to the imposition of personal income taxes by the federal government. The Great Depression gave justification to constitutional changes that transferred to the federal government full responsibility for unemployment insurance and concurrent power over old age pensions. The financing of World War II led to special fiscal arrangements that gave the federal government exclusive power over the collection of personal

and corporate income taxes and inheritance taxes in exchange for cash payments.

From a fiscal federalism perspective, the hardest blow came from the Great Depression, which devastated the finances of federal and provincial governments. Hard pressed to balance their budgets, both orders of governments searched for new revenue sources. The result was a “jungle” of uncoordinated taxes. By 1939, federal and provincial governments imposed personal and corporate income taxes and sales taxes. In addition, the federal government levied custom and excise duties and the provinces levied motor fuel taxes, real property taxes, and collected revenues from natural resources. An attempt at rationalizing the country's revenue system was made in 1935 at a Dominion-Provincial Conference, but without concrete results. A similar fate awaited the meetings of a permanent committee of Dominion-Provincial Ministers of Finance. In 1937, the federal government appointed the Royal Commission on Dominion-Provincial Relations, commonly known as the Rowell-Sirois Commission, to look into issues of taxation, government spending, the public debt, federal grants and subsidies and the constitutional allocation of revenue sources. The Commission presented its report in May 1940. From the perspective of this paper, the most important recommendation was the payment by the federal government of “national adjustment grants,” a set of unconditional transfers aimed at

equalizing provincial fiscal capacity. These “equalization grants” were not simply an attempt to redress existing horizontal fiscal imbalances within the framework of a given federal revenue structure. Rather, they represented a major shift towards fiscal centralization because in return the federal government would have acquired exclusive jurisdiction over personal and corporate income taxes and succession duties. Efforts at implementing the Commission's recommendations were interrupted by World War II, which led to a different kind of fiscal arrangement, the “temporary wartime experiment” known as tax rental agreements.

By the beginning of the postwar period, it had become evident that the conditions that could support a policy of disentanglement no longer

citizenship. In the joint financing of national



**Table 2. Main Recommendations on Equalization in the Federal and Provincial Reports.**

Element	Recommendation	
	Federal Report	Provincial Report
Standard	Ten Provinces.	Ten Provinces.
Coverage	Simplified Representative Tax System, exclusion of user fees.	Comprehensive revenue coverage.
Treatment of Resource Revenues	50 percent inclusion.	100 percent inclusion.
Caps	A receiving province cannot have higher fiscal capacity than the lowest non-receiving province; potential federal cap on total entitlements.	Cap on total entitlements based on federal affordability determined through negotiations between federal and provincial governments.
Volatility	Use of three-year moving average combined with two-year lagged data.	Use of a three-year moving average on data lagged two years.

total entitlements and the allocation of this amount to receiving provinces with moderate or negligible resource revenues. The cap reduces the additional equalization for 2007-08 under the federal Panel from \$1,692 million to \$887 million. The allocation to resource-rich receiving provinces is affected by the 100 percent inclusion of resource revenues in the calculation of a province's fiscal capacity in determining the cap.

In effect, the proposed equalization system has two standards: a ten-province standard for receiving provinces with little or no resource revenue, and an Ontario standard for the resource-rich receiving provinces. Moreover, differences remain in the after-equalization fiscal capacity of non-resource-rich receiving provinces.

This result is shown in Table 3, where the fiscal capacity after equalization for fiscal year 2007-08 is shown as a percent of Ontario's fiscal capacity.

**Table 3. Fiscal Capacity after Equalization as percent of Ontario's Fiscal Capacity under the Federal Proposal, 2007-08.**

Province	Fiscal Capacity after Equalization Relative to Ontario
Newfoundland	100.0
PEI	95.6
Nova Scotia	97.1
New Brunswick	96.3
Quebec	96.8
Ontario	100.0
Manitoba	96.6
Saskatchewan	100.0
Alberta	169.9
British Columbia	105.8

The provincial Panel also recognizes that the combination of a ten-province standard and 100 percent inclusion rate for resource revenues will

lead to a substantial increase in total equalization entitlements. It estimates that what it calls "the fairest and most transparent formula for

determining the overall level of equalization and for allocating payments among the provinces” (p.84) will result in additional equalization payments by the federal government in the amount of \$5.7 billion in 2005-06. To address potential federal concerns about this large increase in entitlements, the Panel recommended a scaling down of the standard through federal provincial negotiations. For example, reducing the standard by one percent would lower its value in 2005-06 from \$6,207 to \$6,135 and would reduce per capita entitlement in each equalization receiving province by \$62. Under the cap, the standard remains a ten-province average, but equalization falls short of this standard for all provinces.

While both reports have to introduce caps in order to constrain the potential increase in total entitlements resulting from their recommendations, the rationale for these caps differ and so does the effect on provincial entitlements. The provincial report suggests only one general cap, a scaling down of the standard which would lower the per capita entitlements of each receiving province by an equal amount. The federal report potentially contains two caps, one based on equity between receiving and non-receiving provinces and the other on federal affordability. The main purpose of the first cap is to prevent that a “have-not” province is transformed into a “have” province by equalization. It affects only the resource-rich receiving provinces that would have after-equalization per capita fiscal capacity higher than that of the non-receiving province with the lowest fiscal capacity. The second cap addresses a vague notion of federal affordability. If the resulting total entitlements after the selective cap “exceed what the federal government is prepared to spend on Equalization in any given year, it should explicitly scale back the entitlements to receiving provinces on an equal per capita basis” (p. 45).

The approach to the general caps in the two reports also indicates different views of inter-governmental relations as they apply to equalization. Equalization is strictly a federal program. The federal government collects revenues from all Canadian taxpayers and transfers a portion of it to the governments of provinces with below-average fiscal capacity. The federal panel takes a strict interpretation of

the federal nature of this program and acknowledges explicitly that the determination of total entitlements is a prerogative of the federal government. The report, however suggests that, in exercising this prerogative, the federal government should not act arbitrarily, but “should outline the parameters for determining the affordability of the Equalization program as part of a number of steps to improve the transparency and governance of the program” (p.45). The provincial report implicitly acknowledges that Equalization is a federal program when it raises the issue of affordability for the federal government. However, it also acknowledges implicitly that, while Equalization is a federal program, it is fundamentally an instrument of fiscal federalism and its parameters should not be determined unilaterally by the federal government. Therefore, it recommends that “the degree of scaling should be negotiated between the two orders of government” (p.88).

In my view, the principle of affordability in the context of Equalization has less conceptual validity than the principle of equity for various reasons. First, increases in total entitlements in the range produced by the simulations in the federal and provincial reports are less than the projected levels of the federal surplus. Therefore, if part of this surplus were used to finance increases in equalization payments, there would be no interference with federal spending priorities. In the context of budget surpluses it is difficult to give a meaningful interpretation to the concept of affordability. Second, even in the absence of federal budget surpluses, the issue is one of policy priorities rather than affordability. If the federal government has sufficient financial resources to finance tax cuts it cannot claim that it cannot afford to raise the level of equalization payments. Third, the share of equalization payments in federal budgetary revenues is substantially below its historical value, as shown in Table 4. This table provides evidence on the decline in the share of federal budgetary revenues claimed by equalization payments. During the first sixteen years starting in 1982-83, this share was 6 percent or more. During the first decade it averaged nearly 7 percent and ranged between 8 and 6 percent. During the second decade the average fell to 6.1 percent and the range shifted down and narrowed to between 6.6 and 5.6 percent. This share is currently slightly under 5



percent and is projected to decline further, reaching 4.8 percent in 2011-12 if total entitlements increase at 3.5 percent year for the entire period. The decline would be more

significant if the potential growth of federal revenues under the current fiscal structure were not curtailed by proposed tax cuts.

**Table 4. Equalization Payments as Percent of Federal Budgetary Revenues: Actual 1982-83 to 2006-07 and Projected 2007-08 to 2011-12.**

<b>Fiscal Year</b>	<b>Equalization as Percent of Budgetary Revenues</b>	<b>Fiscal Year</b>	<b>Equalization as Percent of Budgetary Revenues</b>
1982-83	7.21	1998-99	5.8
1983-84	8.01	1999-2000	6.18
1984-85	7.53	2000-01	5.63
1985-86	6.62	2001-02	5.61
1986-87	6.66	2002-03	4.65
1987-88	6.79	2003-04	4.38
1988-89	6.83	2004-05	5.08
1989-90	6.74	2005-06	4.91
1990-91	6.68	2006-07	5.03*
1991-92	6.08		
1992-93	6.25	2007-08	4.91**
1993-94	6.51	2008-09	4.92**
1994-95	6.58	2009-10	4.93**
1995-96	6.24	2010-11	4.89**
1996-97	6.00	2011-12	4.84**
1997-98	6.01		

\*As proposed in the 2006 Budget and includes one-time adjustments.

\*\*Based on revenue projections included in the 2006 Economic and Fiscal Update and on a 3.5 annual growth rate of entitlements with a base year 2005-06.

Source: Finance Canada, *Budget 2006*, table A3.2; Finance Canada, *2006 Economic and Fiscal Update*; Finance Canada, *Fiscal Reference Tables*.

The compromise solutions presented in the two reports have different implications for the equalization program. In the federal proposal, the treatment of resource revenues influences the total entitlements in two stages, first with the inclusion of 50 percent of those revenues and later with the cap. The cap, in turn, creates three types of provinces: (a) non-receiving provinces, (b) receiving provinces facing an Ontario standard, and (c) receiving provinces facing a ten-province standard. The provincial proposal opens the door to the kind of federal unilateralism that followed the 1977 agreement on Established Program Financing. Under the provincial proposal, the total level of entitlements is exogenously determined through negotiations. Since Equalization is strictly a federal program, and since the constitution mandates neither a specific formula nor a specific federal payment, provinces have no leverage other than political pressures that the federal government may feel from the general public, which depend partly on

the stage of the election cycle. According to the provincial report, inter-provincial differences in fiscal capacity, measured on the basis of a comprehensive list of revenues including 100 of resource revenues, determine how this pre-determined level of entitlements is allocated among receiving provinces. While the selective cap under the federal proposal affects the entitlements of the resource-rich receiving provinces only, the general cap under the provincial proposal (and potentially also under the federal proposal) reduces per capita entitlements by equal amounts for each province.

In my view, these two reform proposal represent a laborious effort at finding a workable compromise that provides receiving provinces with some gains from equalization reform while containing the increase in the financial commitment of the federal government. These attempts at compromises lead to an equalization system that incorporates either arbitrary

components (the 50 percent inclusion of resource revenues in the federal proposal) and complex effects of resource revenues (the special cap in the federal proposal) or an arbitrary determination of the total entitlements (the general cap under the provincial and federal proposals). In the next section I will discuss two options that do not require compromises and place the equalization program on automatic pilot.

#### **IV. REFORM WITHOUT COMPROMISES**

##### *Conceptual Issues*

The history of Equalization in Canada shows how periodic reforms have been influenced by the desire to accommodate natural resource revenues. The recent proposals for reform are no exception. In determining the proper treatment of resource revenues, the federal report stressed a variety of issues. First, it emphasizes ownership: “first and foremost is the fact that, constitutionally, provinces own natural resources within their boundaries. As owners, the provinces determine when and under what conditions a particular natural resource will be developed. This is different from other sources of revenues that are owned privately and simply taxed by provincial governments” (p.57). Second it stresses the volatility of prices. Third, it points out “wide variations in costs of production.” Fourth, it emphasizes “uncertainty over the potential volume of production, and significant changes in profitability.” Finally, the report acknowledges that “there are public costs involved in providing the necessary infrastructure to develop natural resources as well as in monitoring and regulating environmental impacts.”

When one evaluates these and other factors that potentially may influence the way in which resource revenues ought to be treated in the equalization program, it is important to separate them into two main categories, according to the issue they address: (a) those that address the question of whether resource revenues should be included in the list of revenues to be equalized, and (b) how should the tax bases for natural resources be measured if those revenues are included. In the list of factors determining the status of resource revenues found in the federal report, only the first one is fundamentally linked to the structure of the program. It relates to the

fact that fluctuations in resource revenues affect inter-provincial differences in fiscal capacity and total equalization entitlements without corresponding changes in the federal government's revenues. All the other factors are relevant only for the way the resource tax bases are calculated and do not affect the decision whether resource revenues should be included in the list of revenues to be equalized. They become operational only if resource revenues are included.

Resolving the question under (a) requires that we address the following two questions: (i) do resource revenues increase a province's fiscal capacity?, and (ii) should the constitutional constraint on the federal government's capacity to raise revenues from natural resources be considered in determining the federal commitment to the program? The reason why it is important to deal explicitly with both questions is that resource revenues, when they are fully or partially included in the list of revenues to be equalized, affect jointly the number of receiving province, their entitlements and the total federal payments.

The debate among provinces has focused on the first question. Some provinces, notably Saskatchewan and Newfoundland, have given a clear “no” to this question by arguing that non-renewable resources should be excluded from the formula used to calculate equalization payments. In this case, the second question becomes redundant. Other provinces, such as New Brunswick and Prince Edward Island, have answered the first question with a “yes” by arguing for full inclusion of resource revenues in an equalization formula with a ten-province standard. The absence of a cap on total entitlements in their position suggests a “no” to their answer to the second question. The federal government has been focusing on the second question for most of the history of Equalization. The periodic changes in the standard and the treatment of resource revenues, and in particular the recent approach to setting unilaterally the level and annual growth of total payments, may be interpreted as ad hoc solutions to the second question.

The federal and provincial Panels were faced with a variety of conflicting interests. Resource-



**Table 5. Elements of a Two-Stage Approach to Equalization.**

<b>A. Main Elements</b>	
1. Standard	Ten-province
2. Revenues	Comprehensive list of revenues
3. Determination of total entitlements	Based on relative fiscal capacities calculated from a comprehensive list of revenues that <i>excludes</i> resource revenues.
4. Allocation of total entitlements among receiving provinces	Based on relative fiscal capacities calculated from a comprehensive list of revenues with <i>full inclusion</i> of resource revenues.
5. Caps	None
6. Averaging	May not be needed.
<b>B. Calculation Steps</b>	
1.	Start with the allocation of per capita entitlements under a ten-province standard and the full inclusion of resource revenues.
2.	Calculate average per capita entitlements under the full inclusion case above.
3.	Calculate total and average per capita entitlements under a ten-province standard and a comprehensive list of revenues that excludes resource revenues.
4.	Reduce the per capita allocation by province in step 1 by the difference between the average per capita entitlement in step 2 and that in step 3.
5.	Multiply the adjusted per capita entitlements in step 4 by the population of each receiving province to determine total entitlements.

The determination of equalization entitlements under the two-stage approach requires data routinely collected for the equalization program under the pre-Renewal formula and would involve similar calculations. The required steps are outlined in part B of Table 5. The initial step is the calculation of (a) per capita entitlements by province under a ten-province standard and the inclusion of resource revenues, and (b) the average per capita entitlement for all receiving provinces (total entitlements divided by the total population of the receiving provinces). The second step is the calculation of the average per capita entitlement by the receiving provinces under a ten-province standard, but this time excluding resource revenues. The third step is the determination of the adjustment factor, calculated as the difference between the average per capita entitlement with and without resource revenues. The fourth step is the calculation of the adjusted per capita provincial entitlements by subtracting the adjustment factor from the per capita entitlements under full inclusion. The final step is the calculation of the total entitlements by receiving province as the product of a province's adjusted per capita entitlement and its population.

An illustrative example of this calculation, which uses the information contained in the provincial report, is shown in Table 6. Before discussing this example, it is necessary to elaborate on two issues: (a) the meaning of full inclusion of resource revenues and (b) the equal per capita adjustment. With respect to the first issue, the use in my illustrative example of the information from the provincial report takes advantage of the convenience of readily available data and does not imply unquestioned acceptance of the existing approach to the measurement of the natural resource bases. The treatment of natural resources in the allocation of a given level of total entitlements conceptually allows two options only: full inclusion or total exclusion. Either we subscribe to the notion that resource revenues affect a receiving province's fiscal capacity (in which case they are fully in) or we reject that notion (in which case they are totally out). Where there is room for debate is on how we measure those bases once we opt for inclusion. These are technical issues which require technical solutions. In my view, compromise solutions such as the 50 percent inclusion proposed by the federal report are not satisfactory. The issue is not to determine which proportion of resource revenues should be

included in the equalization formula, but what is the most accurate way of measuring the resource revenue bases. In the end, the feasible technical solution may not be perfect, but the effort itself will help improve our understanding of the factors that affect the fluctuations in this revenue base. However this base is measured, it must be included in its entirety in the calculations of the fiscal capacity of receiving provinces for the purpose of allocating a given amount of total entitlements.

The use of an equal per capita adjustment in the determination of the final per capita entitlements by receiving provinces follows the approach suggested by the provincial report in its example of a scaled-down ten-province standard

option has a different level of total entitlements. Finally, the provincial report separates basic equalization and the equalization associated with federal transfers for health care, post-secondary education and social services. In order to facilitate comparisons with the provincial report, which contains the information used in my calculations, I also confined my analysis to basic equalization. The federal report shows results only for the combination of the above two components. In order to provide a consistent comparison for fiscal year 2005-06, I subtracted from the results presented in the federal report the associated equalization shown in Table 6.1 of the provincial report.

With these caveats in mind, the allocation of different levels of total entitlement under the pre-Renewal system, the 553 (sy)-7- under the federal, the 55.3 (pt - TD0.6e)2(i)ccen f4NSn(tent )]TJn of 4027on

Table 9 compares the fiscal capacity among provinces for three options before and after equalization. The first option is the continuation of the pre-Renewal arrangements (called pre-R) and the second option is the preferred provincial option. The relevant data for these two options are found in Table 1 of the provincial report. The third option is the two-stage approach introduced in this paper. For each option, this table shows per capita fiscal capacity before equalization in the first row, per capita equalization entitlements in the second row and after-equalization fiscal capacity in the third row. The fourth row shows a province's after-equalization fiscal capacity as a percentage of the average for the selected standard. For the two-stage approach, the first row is based on Table 1 of the provincial report and the second row on Table 5 of this paper. A meaningful comparison with the federal option is not possible because data on pre-equalization per capita entitlements are available only for 2007-08 but include associated equalization for which the federal report shows no information and the provincial report shows details only for 2005-06. Information on the after-equalization per capita fiscal capacity under the federal proposal is shown in Table 3.

A comparison of Tables 3 and 9 combined with the information on the elements of each proposal presented in this paper allows an evaluation of the four proposals for internal consistency, interpret





process of financial planning for provinces.

